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60/40:
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60/40: IS THERE LIFE IN THE OLD DOG?

It's tough being a Chelsea fan. With a month of the season remaining, the club is lying in mid-table having lost more games than they have won.

Many supporters and pundits expected better given that a new owner arrived during the summer and has spent more than any other Premier League club on talent at around £550m.

Pension schemes employing a traditional 60/40 investment strategy will know how it feels to underperform. The model of holding 60% of your assets in equities for growth and the rest in bonds for protection when times are bad fell by 16% last year leaving some to question its effectiveness.

Our cover story this month looks at if the traditional investment model has had its day or if rumours of its demise have been greatly exaggerated. You can read our findings from page 18.

This edition also examines the impact the DB funding code could have on trustees, what the future holds for local government pension scheme pools, and the threat that could be as catastrophic as climate change. Find out what that is from page 42.

If that's not enough, we also find out what responsible investment means to Railpen, while this month's roundtable focuses on emerging markets, which are characterised by higher growth but lower ESG disclosures. We find out what investors are looking for from page 28.

We also speak with the pensions minister, Laura Trott, about investing in Britain and how she intends to hold underperforming defined contribution schemes to account (page 12).

Some will welcome her views, while others will disagree. Either way it would be good to hear your thoughts on what the minister has said.

One final point, this is the last edition of *portfolio institutional* that Mona Dohle has worked on. After five years, our reliable deputy editor has decided to take the next step in her career. Andrew and I wish her the best of luck for the future.

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UK PLC GOING PRIVATE AMID TAKEOVER SURGE

What does private equity firms eyeing up London-listed companies mean for institutional investors? *Mona Dohle* reports.

This year has seen a resurgence of private equity interest in UK-listed companies. A growing number of businesses, including online retailer THG, credit card processor Network and oilfield services platform John Wood are in takeover talks with private investors.

The renewed demand follows a global slump in private equity deals last year, as rising rates lifted valuations. In 2021, the industry spent more than $1trn (£800bn) globally to beef up its portfolios, before activity slowed, according to consultancy Bain & Co.

During 2021, private equity firms signed a record 863 transactions in the UK, but the deal count fell by 15% last year, according to KPMG.

Dry powder

But there are also record levels of dry powder in the market, with global firms sitting on a whopping £3.7trn in cash to be deployed, according to Bain & Co. Claire Trachet, chief executive and founder of the eponymous advisory firm, said that last year's uncertainty has caused a reluctance to invest. "This means there are significant opportunities on the horizon, and now is the moment to prepare and get deal ready as optionality will increase in the second half of this year," she predicted.

Indeed, the resurgence in buyout talks is a sign that investor appetite is picking up again and UK plc could be on the menu. One reason is that UK-listed companies are seen as relatively cheap compared to the US market, a factor reinforced by the relatively high value of the dollar compared to sterling.

Sterling slumped to a record $1.12 (89.6p) low last autumn amid political turbulence. It has since recovered to $1.24 (99p) but still offers US investors relatively greater purchasing power.

A survey conducted by stockbroker Numis last year found that more than 70% of UK-based private equity investors focused on domestically-based firms. More than 90% of respondents said they were eyeing UK listed corporates in take-private deals.

But Trachet also warned about the lack of capacity in the UK to execute these deals.

"Although this is a positive reflection on the UK in terms of what has happened to date, it also signals how there is no one in the UK big enough to act on these acquisitions, showing us that a lot of the financial power for deals lies outside the UK. This leaves us with a question mark of what will happen next," she said.

Bargain bucket

Renewed interest in UK markets has sparked political controversy in the past as some private equity firms have snapped up firms such as supermarkets Morrisons and Asda at bargain prices.

Asda prides itself in offering affordable deals but was acquired by private equity investors for £6.8bn in 2021. A bargain bucket, it appeared, as a year later the new owners valued the firm at 20 times what they paid for it.

The growth in take-private deals raised concerns about the future of UK plc with the number of companies trading on the London Stock Exchange shrinking by more than 12% during the past three years, according to the Quoted Companies Alliance.

Shareholders are increasingly concerned that public firms are being sold at a discount. For example, a private-equity takeover of conference organiser Hyve faced opposition from several shareholders, including M&G Investments. Shareholders argued that the deal, which priced the events business at £363m, significantly undervalues the firm.

They are concerned that private takeovers of UK firms might be motivated by a short-term hunt for profit and not to invest in long-term development.

Political push

The growing UK private market could be an opportunity for some institutional investors, including local authority pension schemes and defined contribution providers, who are increasingly eyeing private markets in a bid to diversify their portfolios.

This trend is heavily promoted by the government, which has launched the Patient Capital Review to attract more cash into private markets.

The same objective is also being followed by the Value for Money Consultation and the local government pension scheme pooling consultation.

Examples of private equity mandates include Border to Coast, which last year launched a £5.7bn private markets programme, with Nest announcing a £1.5bn private equity mandate. Wales Pension Partnership joined in earlier this year by committing £500m to the asset class.

The growth in private equity also raises concerns about the role of ESG standards for privately listed firms, with those for engagement remaining more complex for unlisted firms. The FCA's new anti-greenwashing rules will apply to any UK-authorised firm and, therefore, also private equity funds.

REGULATORS SET OUT NEW APPROACH TO LDI

Two regulators raise the bar in terms of investing to manage a scheme's liabilities, finds *Andrew Holt*.

The Financial Conduct Authority (FCA) and The Pensions Regulator (TPR) have laid out their expectations on the future of liability-driven investment (LDI), mapping out how the market needs to evolve.

TPR has introduced a new minimum 250 basis points (bps) buffer, which must have scope to be replenished within five days. It also wants to see an operational buffer sufficient to cover day-to-day volatility.

This is a direct response to the crisis created by last year's LDI debacle, which had a huge impact on pension funds.

An operational buffer of 100bps was the standard methodology, and the conclusion reached is this is no longer satisfactory.

This could potentially have a big impact, said Sinead Leahy, managing director at Cardano, the investment management firm behind Now Pensions. "TPR guidance regarding collateral buffers will mean that some pension schemes will need to review their return objectives and level of hedging, as it won't be possible to continue hedging to the same degree and target high returns and meet the new collateral guidance. Choices will need to be made," she added.

The FCA set out a clear theme of greater accountability through-out the decision-making chain in relation to LDI and other similar investments.

LDI managers must be satisfied that the choice of investment is suitable for the investor in the context of their intended outcomes and wider arrangements.

The FCA explicitly mentions considering the benefit of segregated versus pooled funds, recognising how the operational flexibility of segregated funds was advantageous during last year's crisis.

More information

Furthermore, LDI managers will need to obtain detailed up-to-date information about a scheme's wider arrangements, which would typically be greater than is readily available in the scheme's Statement of Investment Principles.

However, it is not clear at this stage how any new responsibility on LDI managers will be monitored or enforced.

A natural implication is that there will be some level of increase in client servicing. If this went as far as the LDI manager having a duty of care on the end investor, this could also increase risk for the LDI manager.

These factors may well result in higher fees charged to pension schemes to compensate the manager – a point that will not please asset owners.

Simeon Willis, chief investment officer at consultancy XPS Pensions, said a theme running through the FCA announcement was one of all participants sharing greater responsibility for LDI arrangements. "A higher bar is being set," he added. "It's clear that a siloed approach from investment manager or investment adviser, narrowly focused on their own role alone, is insufficient to meet expectations.

"Everyone involved in the decision-making chain should be demonstrating that they are considering the suitability of the investment for the end investor and the resilience of that investor's overall arrangements."

This means, Willis added, that LDI managers will need to ask questions about what a client is trying to achieve by investing in the LDI fund. "So, it can satisfy itself and evidence that the fund is the best approach all round," he said.

These outcome focused developments mirror the messages that have emanated from discussions around the responsibilities of regulators themselves. For example, the Bank of England's recommendation that TPR set an additional objective around financial stability.

Covering the cracks

This overlapping approach has been proposed as a means to ensure key matters of systemic importance don't slip through the cracks. For all involved, particularly investors, this is no bad thing.

Sinead Leahy added that LDI has to be looked at in a wider historical perspective, and not just in reference to the crisis of late last year.

In such a context, LDI has served, Leahy said, as an invaluable tool for pension schemes for the past 20 years, resulting in many schemes being in stronger funding positions and with lower dependencies on their sponsoring company.

"Overall, the system and use of LDI is not broken and what we saw at the end of last year was an extreme event that was not foreseen by the market," she added. "However, there have definitely been winners and losers. And so, it is important that trustees and sponsors effectively run a 'health check' on their mandate."

But the path set out by the regulatory bodies will change the LDI game. "Unfortunately, you can't have your cake and eat it," Leahy said. "As the FCA and TPR guidance says, the focus should not just be on collateral management and governance but also look at the operational side of the overall LDI mandate – how is the process managed, monitored and acted upon."

Therefore, Leahy recommended a checklist for investors: a review of operational resilience and governance is essential together with the need to revisit journey plans, desired end-game options based on the funding position, hedging and leverage positions, and updating growth asset outlooks.

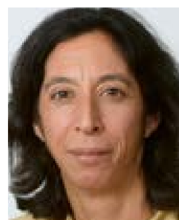
PEOPLE MOVES

Harrow Council has recruited **Bola Tobun** as its treasury and pensions manager. She brings more than 20 years of local authority pension fund experience to the role.

Tobun (*pictured*) has joined from Enfield Council, where she spent more than three years covering pensions and treasury.

She has also been investment and treasury manager for Tower Hamlets Council and spent seven years as an independent business consultant for Lewisham's pension fund.

Nest has promoted **Liz Fernando** to chief investment officer after Mark Fawcett's 14-year tenure ended.



Fernando (*pictured*), who joined the government-backed workplace pension provider in 2020, moves up from deputy chief investment officer to lead the day-to-day implementation of the investment strategy.

Fawcett continues to manage the provider's investment strategy as he remains chief executive of Nest Invest and retains a seat on Nest's executive committee as managing director of its investment function.

Guy's & St Thomas' Foundation has appointed **Emma Davies** as its new chief investment officer.

Davies will be responsible for implementing the investment strategy of the £1bn charitable endowment which aims to make positive health impacts.

She replaces Ethan Hall, who has held the role since 2021.

Davies brings a range of experience to the foundation having held positions at Octopus Ventures, JP Morgan, Perry Capital, The Wellcome Trust, Marylebone Partners and as the founding chief investment officer of Big Society Capital.

Independent professional trustee specialist **Dalriada** has named **Chris Roberts** as its new chief executive.

An almost 12-year veteran of the firm, Roberts joined the board in 2019. He helped establish Dalriada's Manchester office and is the trustee chair for several pension schemes.

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

Dalriada has also welcomed six new faces to its senior leadership team. **Sarah Ballantyne**, **Amanda Banister**, **Judith Fish**, **Jo Harris**, **Julie-Anne Jones** and **Charles Ward** have taken seats on its practice board as directors.

NOTICEBOARD

NatWest Group Retirement Savings Plan has joined a group of European asset managers and Japanese institutional investors to invest €390m (£345.8m) in renewable energy.

The capital will be managed by Legal & General Investment Management and renewable energy specialist NTR.

The funds will be invested in wind, solar and energy storage assets in Europe.

Local government pension scheme pool **Border to Coast** has secured £2.3bn from its partner funds in the second round of its private markets programme.

The pool has now raised £12bn since it started investing in private equity, private credit and infrastructure in 2019. More than £9bn has already been deployed.

Elsewhere, more than 22,500 current and former supermarket workers at Safeway have had their retirement benefits secured in a £1.4bn deal.

The **Safeway Pension Scheme**, which is sponsored by supermarket giant Morrisons, completed the buy-in with **Rothesay**.

Meanwhile, the trustees of the **Ibstock Pension Scheme** have completely insured its longevity risk following a £190m deal.

The buy-in with the defined benefit scheme for the brickmaker was covered by **Just** and builds on a £340m transaction agreed by the two parties almost three years ago.

Just has also agreed a buy-in with the trustees of the **Carillion Group of the Electricity Supply Pension Scheme**. The £15m deal, which was agreed above the level of Pension Protection Fund compensation, secures the benefits of all 122 members.

The scheme, which fell under the protection of the pensions lifeboat when construction giant Carillion was liquidated, is now expected to move towards buyout.

Around 200 retired and deferred members of mattress-maker **Sleepeezee**'s pension scheme have had their benefits guaranteed by Legal & General.

The £18m buy-in covered members of the Sleepeezee Retirement Benefits Plan 1975.

Finally, in what has been a busy period for Just, it has agreed a full buy-in with the trustees of the pension scheme sponsored by **Consort Equipment Products**.

The £4m deal covers the benefits of 31 pensioners and six deferred members who work for the electric heating manufacturer.

THE BIG PICTURE: BARGAIN HUNT

Weighted EU index price/fair value estimate for Morningstar's European coverage

Source: Morningstar Direct

There is real value in equity markets, finds *Andrew Holt*.

Equities had a good start to the year, seeing some impressive increases. That changed mid-March due to the banking sector. But by the end of the quarter, equity markets rallied again.

It is on a valuation basis that the equities story takes shape. Every sector across Morningstar's coverage universe continues to trade below its fair value estimate.

An unusual, but welcome scenario for investors.

Sectors such as industrials are trading close to their fair value estimates, while others, like consumer cyclicals and communications, look particularly attractive.

Based on Morningstar's valuations, the group continues to see the best positioning for long-term investors in a 'barbell-shaped portfolio': overweight value and growth stocks, which are 15% and 16% undervalued, respectively, and underweight core stocks, which are trading closer to fair value.

By market capitalisation, small-cap stocks remain the most undervalued on a 25% discount to fair value. And the most undervalued category in the Morningstar Style Box is small-cap value, trading at an almost 40% discount to fair value. Whereas the large and mid-cap categories remain at a discount similar to the broader market.

Defensive sectors slipped below fair value but are fully valued on a relative basis as compared with the rest of the market.

Within economically sensitive sectors, energy was the worst performer, yet ironically the most overvalued.

Communication services fell slightly more than the market, but remains a highly undervalued sector – trading at a 37% discount to fair value.

The most notable move mong the cyclical sectors was real estate, which became even more undervalued, and is now trading at a 15% discount to fair value.

The conclusion is therefore simple: for investors looking for a bargain, there are many to be found.

Although one big proviso is that like any market opportunity, confidence is key. And for the market to achieve the hoped for gains, investors will need to be persuaded that the economy will be in a better place by the start of next year. All the signs, thus far, are that it will.

Maggie Rodger is co-chair of the Association of Member Nominated Trustees (AMNT).

MEMBER-NOMINATED TRUSTEES AND THE EMPEROR'S NEW CLOTHES

With the latest round of consultations ending and the liability-driven investment issues and inflation beginning to settle, perhaps trustee boards can begin to draw breath. Most are well into considering where their scheme now stands and whether their previous journey plan needs to be revised in the light of circumstances, market movements, and the proposed funding and investment strategy plans. The latter, along with the Guaranteed Minimum Pension and pensions dashboard, will be our tasks in coming months.

The position of a member-nominated trustee was introduced post-Maxwell to ensure there is a board member whose role is to act as guardian of the scheme for members. Does this still apply today? How does a member-nominated trustee, who has probably been elected or selected onto the trustee board with a variety of skills, but might not possess professional investment knowledge, cope with this world? To be responsible for the retirement quality of others is a huge responsibility (even with all of the investment advice open to us). And one which member-nominated trustees do not take lightly.

But, it needs to be remembered, that, a good pension scheme is built on more than good investment and investment governance alone, although they may match up more closely at the other end of the spectrum. Good administration and communications are also the hallmark of good schemes, but these skills rarely all reside in the same person.

On the trustee board, a variety of skills and experience are needed. But perhaps the most important skill, in investment as in all the other areas, is the ability to read and absorb a constant flow of new material and, vitally, to ask questions. So as lay trustees, individually and with the rest of our boards, we need to train and continually learn.

New challenges or investment products are always being put forward, either because our schemes are: changing their strategic plan; because of the stage of the journey they have reached; new regulation; market conditions; or possibly all at once. Among all the investment jargon and acronyms, the presentations or reports with long appendices full of charts and figures, it's easy to forget that at heart there are some fairly basic questions that need to be asked.

Whatever the investment product being suggested, trustees need to ask: what is the expected return? Have we identified all the possible risks? And, as ESG has become such a fundamental issue, am I happy for my return to come from this source if it affects the future world for members' retirement? In essence, however excellent the investment seems, – how well does this fit my scheme, its size and journey plan?

Because the pensions investment industry is so well connected and informed, with multiple daily newsletters, frequent webinars and conferences there is, perversely, a huge danger of groupthink. If every article we read is about something new or the "right answer" to a pensions problem it is far too easy for it to be adopted without sufficient thought. Have we looked at all the risks in the context of the rest of the portfolio for this specific scheme?

That is the point of member-nominated trustees. They have the potential to bring a different life experience and perspective from the 'industry voice' and that doesn't mean just a better knowledge of the member. Member-nominated trustees have the freedom to probe and to ask questions at a level experts may not be paying attention to. The point of member-nominated trustees is to be not just a member voice but an independent, non-pensions industry voice. Diversity in all its forms is vital. Member-nominated trustees should not be afraid to ask awkward or "silly" questions. In fact, it is often a helpful part of the process to avoid groupthink. Sometimes it may make us feel as if we are standing among the cheering crowd and querying the Emperor's new clothes. But, on occasion, that is a position that needs to be taken for the protection of all.

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WILL ECONOMIC CONDITIONS ACCELERATE DC ALLOCATION TO ALTERNATIVES?

After decades of economic stability, the past three years have brought challenges and uncertainty that will define the economic landscape for years to come.

Pragmatism and a long-term focus have served defined contribution (DC) schemes well so far, helping members' savings to weather the storm of high volatility and significant declines in the stock market during the early period of the pandemic. But more recent bouts of turbulence seem likely to be a longer-lived trend, representing a fundamental shift in the economic landscape.

While a pragmatic, hold-steady approach worked well in response to short-term market shocks, long-term challenges that could produce a 'new normal' for the way our economy functions will require a more proactive approach.

The traditional passive equity/bond split worked well under the economic status quo of the past three decades, so it's unsurprising that it continues to dominate DC investment. But evolving challenges require innovative solutions.

Challenging economic times have re-emphasised the importance of a well-diversified portfolio. Schemes appear increasingly focused on evolving and improving investment strategies and demonstrating value for money. There is more focus than ever on alternative assets and the role they could play in delivering better outcomes.

The government's productive finance agenda aims to facilitate and encourage greater investment in alternative, particularly illiquid, assets. DC scale continues to grow, and the introduction of new investment vehicles, such as long-term asset funds (LTAFs), should help to alleviate availability challenges. With current economic challenges leading investors to look beyond traditional investment strategies, there could be a longer-term re-evaluation ahead for DC schemes and a subsequent acceleration of investment into alternative assets. But this will depend on how effectively we can overcome the challenges that remain.

While scale has grown across the DC market, it continues to be a challenge – particularly in relation to illiquid alternatives. Greater scale allows for larger upfront investments, as well as diversifying across sectors and investment horizons.

Smaller schemes are less able to access the potential diversification benefits and are more dependent on the offerings of external platform providers. As the DC market grows, these challenges should become less relevant. Assuming current trends continue, the aggregate value of workplace DC assets could grow to around £1.03trn during the next 20 years. Shorter term, if larger schemes find ways to work through operational challenges (e.g., liquidity, governance and structuring of contracts), then scale should become a less significant issue, with smaller schemes able to learn from the implementation of larger schemes leading the way.

Some DC scheme trustees are likely to need greater support to build their knowledge on alternatives. With such schemes having historically invested primarily in equities and bonds, expertise on the details and nuances of alternative assets is not as developed as in the defined benefit market. Even among trustees who may have a good understanding of alternative asset classes, there can be a reluctance to engage, whether because of risk or cost. Some schemes, particularly at the smaller end of the market, may need to rely more heavily on the expertise of external consultants and advisers if they are to increase their engagement with alternative investments effectively.

It's also important to recognise the dynamics of the DC market – one of the key challenges being the way in which DC schemes, and especially master trusts, are expected to compete primarily on cost, often on small margins. Shifting towards a more holistic approach to value for money is a key priority, with The Pensions Regulator/Department for Work and Pensions framework on metrics, standards and disclosures consulted on between January and March this year. It's hoped this will lead to a greater focus on the value that investments can add, rather than an over-emphasis on low costs, and improve member outcomes by enabling more diversified portfolios that better mitigate risks in an uncertain economic landscape.

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INTERVIEW – LAURA TROTT

"We have to get defined contribution right."

Pensions minister Laura Trott sits down with *Mona Dohle* to discuss the lessons from the LDI sell-off, the DB funding code, fairness, a focus on returns, investing in Britain and why she is willing to hold schemes to account.

Congratulations on your appointment as pensions minister. How have the first few months been?

It's the best job in government. It offers an opportunity to touch everyone in this country and to make a difference to their lives.

You took on the role at a challenging time, when liability-driven investment (LDI) was making global headlines for the wrong reasons. What lessons can be drawn from that crisis?

I've spoken in front of the Work and Pensions Select Committee for a couple of hours on this. Broadly, LDI has done its job over a number of years in improving scheme performance. Funding levels are now in excess of 130% for defined benefit schemes, so we are in a good position, which is great news for the savers in those schemes. Of course, there were issues which have been identified and it's right that The Pensions Regulator and the Financial Conduct Authority have taken action around collateral buffers.

Also, the regulation around pooled funds is something we need to look at. Most schemes met their margin calls really well but some pooled funds found it harder, so regulation in that area is important.

Related to this is the second round of the DB funding code consultation, which has just closed. There have been calls to push back its implementation until next year. What is happening with that?

We are looking at it. We will make sure we consider the findings of the Lords Select Committee, which we have had, as well as the Work and Pensions Select Committee findings when that comes through.

One criticism of the DB funding rules is that they are pushing schemes into LDI strategies. Is there now a greater level of consideration that open DB schemes need to pursue a different investment strategy than closed DB schemes?

Obviously, the exact investment decisions are a matter for trustees not for the government, but yes, open and closed DB schemes need to be treated differently.

So risk measures should be different?

Exactly.

Moving from DB to DC: in January, you presented the Value for Money proposals, and it sounds like something you are passionate about.

I am passionate about pension savings and see my job as being on the side of pension savers. It's important that we boost

fairness, adequacy and predictability. Fairness is at the heart of the Value for Money proposals because it is massively different how adequate your pension is going to be depending on investment returns. And there is so little understanding and focus on returns.

I want to switch the focus from costs to returns. That is what Value for Money is going to do.

Three pensions ministers have looked over these proposals, so how much of Laura Trott is in them?

Whenever you take over a new brief, there are things in the in-tray that you have to decide what to do with. Whether you want to continue with them, change them or stop them altogether.

I am excited by the Value for Money proposals because they have the potential to boost returns for savers and that is what I am about. I want people to have the retirement income they want and deserve and Value for Money offers a massive opportunity to do that.

This is part of an overall vision I have in terms of how we are going to boost returns for DC savers in particular.

When people talk about pensions, too often, they only talk about defined benefit pensions. But that is not the world that many people are going to be entering into, which will be a lot more focused on defined contribution schemes.

Most [defined benefit] schemes are now closed. For most people, the pension they are paying into will be a defined contribution pension. We have to get defined contribution right.

At the moment, pot sizes are quite small but they are going to be a lot bigger as the effects of automatic enrolment kick in.

We have to get this right. I want to make sure these defined contribution schemes are doing everything they can to deliver a decent retirement for people.

Could we see a paradigm shift from a focus on cost, which dominated in the early stages of auto enrolment, to a focus on investment outcomes?

Absolutely, because that will make a massive difference in terms of income. The stats on this are completely extraordinary in terms of the difference it will make on eventual pension outcomes.

One of the complications you just hinted at is that even within individual schemes, outcomes for different members can be different. How can this information be presented in a way that is more member focused?

We tried to focus the initiative mainly at pensions professionals to ensure that the schemes members are enrolled in are delivering a high value for money. We will have to look at how it works and make sure it is being effective. Then we can look at how we can expand it.

There is also talk of including forward-looking data on investment returns. How can you make sure such data is reliable?

As you rightly point out, this is part of a wider set of data we will be collecting. It's important to understand where you are going to get to and then you can always compare it afterwards.

We would say to DC providers: "You thought you were going to get these returns, but what actually happened? And how ambitious are you going to be in terms of returns for savers? We will then evaluate their answers going forward. But it's not just one metric that we are looking at.

Why haven't ESG metrics been included in the Value for Money proposals?

There is already a huge amount of regulation on ESG and environmental metrics more broadly within pensions. What this is looking at, with a laser-like focus, is boosting returns for pension savers. That is why we only include things that will impact people's retirement when they withdraw their cash.

Could greater transparency on asset allocations push schemes into the same asset types, a bit like DB schemes where a lot of money has gone into gilts?

Transparency is important for scheme members to understand where their money is being put. Going back to investment decisions are a matter for trustees, we need to make sure at the aggregate level that they are delivering for pension savers. If we look, for example, at illiquid investments. I hope to see more of them because they generally deliver higher returns for savers and we are underinvested in the UK compared to other areas. We invest around 7% versus up to 19% in other markets.

They also have higher fees and there is controversy around that, isn't there?

The changes we are making around automatic enrolment are huge.

Yes, but fees are only paid if they deliver. This comes back to the shift from cost to returns because that will make the difference.

As part of that push for more investment in illiquids, you have announced more exemptions to the charge cap. What do you hope to achieve with that?

This comes back to the central point that as a country, we are underinvested in illiquids compared to elsewhere and we know that illiquids tend to have higher returns.

This is about removing barriers to make sure we are allowing DC schemes to invest in higher returns for members.

If you are not getting the returns you should be getting, we will take action.

The Lord Mayor of the City and people in the fund industry would like to see a mandatory DC contribution to infrastructure. Is that a good idea?

I understand why people would be calling for that and I am clear that I would like to see more investment in illiquids because it benefits pension savers and I see my job as being an advocate for pension savers.

There are wider economic considerations which are important, so those debates are interesting. If you could show that it would increase returns for pension savers I would be interested in it.

But it is critical that we at the Department for Work and Pensions do not allocate where the pension schemes place their money. It's important that we do not do that.

What I want to do is make sure we judge schemes on how they are performing, that they are getting the returns savers need. If they are not, they need to either consolidate or exit the market.

We have to remove barriers to allow them to seek those higher returns. That is how we are trying to do it.

Sounds like you are favouring more of a market-based approach rather than a mandatory infrastructure contribution?

I am looking at trying to encourage people to do things which will benefit pension savers with clear regulation around it. We are prepared to be interventionist where those returns are not being delivered.

People are not engaged with their pensions so they often don't know that the provider they are with might be making poor returns. That is not good enough, and I am comfortable in saying that.

Where schemes are poorly performing, The Pensions Regulator will step in and say that they have to either improve or exit the market.

So yes, I am happy for trustees to be given freedom on investment decisions but we will hold them accountable.

How tight will those rules be?

Much tighter. These are new powers that would be linked to the Value for Money framework.

Of course, the consultation has now closed and we are going to be responding to that consultation. But the idea behind it is that we are not just collecting data for the sake of it. The information is going to be standardised and published.

What we are saying is that on the basis of this data, The Pensions Regulator is going to be empowered to tell schemes that they either need to improve, consolidate, fold in or exit the market.

So we could be seeing a smaller number of master trusts?

Yes.

We have been talking a lot about infrastructure but it's not a risk-free asset class. If investing in infrastructure is being incentivised through policy, how are you planning to protect DC savers from the investment risks?

It is important to consider – and Andrew Griffith, the economic secretary to the Treasury, talked about this when we were at the Work and Pensions Select Committee – that nothing is risk free. But there are protections in place for savers and we know that in general, illiquids produce higher returns, so that is why this is important.

Ultimately, it will boost adequacy, which is what we want to see. But it is a well-regulated sector and the overall performance is being monitored. That is the whole point of the Value for Money framework. If you are not getting the returns you should be getting, we will take action.

So, nothing is risk-free, but I am comfortable that there is a framework around this that will protect savers and hopefully boost their retirement income.

That is why I am so passionate about returns. The compound effect of that is enormous. Every year makes a difference.

I feel that there is a sense of urgency in making sure we are doing all that we can for DC savers.

The emphasis for adequacy has been on returns, but there has been talk that auto-enrolment contribution levels should be increased.
There was a recommendation in the auto-enrolment review around reducing the age, which is one of the first steps I have taken as a priority. We should get those in place and then look at what more we can do.

The regulator has authorised the first Collective Defined Contribution (CDC) scheme in the UK. Could such schemes play a greater role in future?
CDCs are interesting. They have the potential to become an interesting part of the pensions market because they take away some of the investment risks by sharing them. It also means that when it comes to retirement, you don't have the same life-styling factors you would have otherwise.
It is interesting and something we are looking at. For multi-employer CDC, we are looking at how we can go further on those. That has the potential to be interesting.

Do you get the sense that there is an appetite for CDC in the DC industry?
Absolutely. We are talking to a lot of people about this at the moment.

On the DC side I take it?
Yes.

So CDC could potentially take a greater share of the UK pensions market?
That could be an interesting development in the UK pensions market and it is one I am keen to push forward.
We have consulted on the multi-employer consultation that has just closed and looking at what we can do.

So you can't tell me more about that right now?
It's work ongoing, so I can't comment. But I am clear in terms of my enthusiasm for this and my desire to push it forward.

What are your ambitions for the medium term?
I want to increase fairness, predictability and adequacy. Fairness means talking about the fact that between schemes there is a huge disparity. I want to reduce that disparity between DC schemes but also between DC and DB schemes. There is a gulf which I am keen to narrow.
On adequacy: everything we talked about here is about adequacy. I am passionate about adequacy and making sure that we have higher returns so that people can get the retirement they want.
Every day I feel the pressure of making sure we boost those returns because the compound effect is huge.
And predictability is just about people knowing a bit more about what they have and what they should expect. Part of what we are doing around small pots is around that.

LAURA TROTT MBE

2022 – current
Parliamentary Under-Secretary of State
Department for Work and Pensions

2019 – current
MP for Sevenoaks and Swanley

2015 – 2017
Partner
Portland (PR & communications)

2015 – 2016
Political adviser, director of strategic communications 10 Downing Street

2012 – 2015
Political adviser, head of education and family policy No.10 Policy Unit

2010 – 2012
Special adviser
Cabinet Office

2009 – 2010
Political adviser
Conservative Party

Everything we are doing around small pots and around dashboards is aimed at that, ensuring that people know what they are going to get and understand what they can do to boost that as well in terms of increased contributions and making sure they get higher returns from their pension provider. There are lots that people can do in making sure they have an adequate pension.
The changes we are making around automatic enrolment are huge. We have the private members bill going through at the moment. That is going to be massive. Shifting the auto-enrolment age to 18 and making sure that people pay from the first pound they receive is a big change. I'm passionate about doing this.

The regulation around pooled funds is something we need to look at.

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60/40: IS THERE LIFE

Those believing that last year's disastrous performance for 60/40 portfolios confirmed its death as an investment model should not be too hasty, warns *Andrew Holt.*

IN THE OLD DOG?

Given the unpredictable times in which will live, the investment model for success may well seem aloof. How is an investor to make the best of a situation where all models seem to be full of flaws, to some extent.

At the centre of the debate, as it usually is, stands the issue of the trusted 60/40 model. Many questions surround it. Is it dead? Is it still relevant? Recent history suggests that possibly both of these are true.

This most traditional of portfolios had a truly disastrous 2022 – performing worse than Chelsea football club – falling by 16%. That would put it beyond mid-table and closer to the relegation zone. One could counter this by pointing out that few asset classes emerged unharmed from last year's market devastation.

But some investors suggest its relevance is non-existent. Jason Fletcher, chief investment officer at local government pension pool London CIV, says that, for him, the investment model is derelict. "60/40 has not been a basis for investing by open defined benefit pension funds for 30 years," he says. "The introduction of alternatives and private markets has changed the picture.

"Asset owners have tended to move to growth-income and stabilising asset categories with an overlay for liquidity and ESG requirements. Note that correlations between bonds and equities change over time, as do the relative risk dynamics," he adds.

This is a pretty dismissive assessment of the 60/40 portfolio and an insight into why it will not be the investment answer for DB schemes.

Bouncing back

But it is not the whole picture. Neil Mason, assistant director and local government pension scheme senior officer at the Surrey Pension Fund, offers the perspective that the continuing relevance of traditional 60/40 portfolios rests on the assumption that returns from equities and bonds are negatively correlated. "This being the case, diversification of this type does reduce portfolio risks," he says.

But current macro-economic circumstances have corrupted that idea. Higher interest rates and inflation volatility have been negative for bonds and equities alike. This meant the positive equity-bond correlations have been less successful, to say the least.

Some blame could be laid at the feet of the Fed and its peers. "Central banks have approached this current inflation environment as if flares and long hair were all the rage," Mason adds.

"As they only appear to have a hammer made circa 1970, everything looks like a nail, despite evidence that raising interest rates will be counter-productive by reducing the likelihood of investment in the structural changes needed to the supply side infrastructure that caused the inflation in the first place," Mason says.

Jean Boivin, head of the BlackRock Investment Institute, has a similar take on the 60/40 debate, starting with how stocks have bounced back – and what this means. "Stocks and bonds have rallied this year. Some see this as reason to return to traditional portfolio approaches like 60% stocks and 40% bonds," he says, adding: "Those used to work when both assets trended up and bonds offset equity slides."

Expanding on this, he notes that sticking to a 60/40 mindset could be restrictive for investors. "A focus on any one asset allocation mix misses the point," Boivin says. "A regime of higher volatility with sticky inflation needs a new approach to building tactical and strategic portfolios. We see the appeal of income getting more granular with views and are more nimble."

Central banks have approached this current inflation environment as if flares and long hair were all the rage.

Neil Mason, Surrey Pension Fund

Strong foundation

This presents a potential different approach to investment. And while this may shift the breakdown of a portfolio, there are reasons to suggest 60/40 is not dead at all. Albeit a slightly contrarian conclusion.

An allocation based on the traditional investing approach of using broad, public indexes of 60% equity and 40% bonds is having a strong start to 2023 after 2022 had been the worst year in decades. This is potentially a good foundational starting point for the 60/40 scenario to build on.

Boivin recommends that investors start with income. "The longer rates stay higher, the greater the appeal of income in short-term bonds," he says. "We see interest rates staying higher as the Federal Reserve seeks to curb sticky inflation – and we don't see the Fed coming to the rescue by cutting rates or a return to a historically low interest rate environment."

This though reinforces the appeal of income in short-term paper. "We also see long-term yields rising on strategic and tactical horizons as investors demand more term premium, or compensation, for holding long-term bonds in an environment of higher inflation and debt," says Paul Henderson, senior portfolio strategist at the BlackRock Investment Institute. So 60/40 lives, albeit in a varied form.

Effective investment

Beyond this potential meddling with portfolios there is a case of how 60/40 is an effective, viable investment strategy going forward. Leading to a point where 60/40 is not just viable, but one in which it is truly back from the dead. This argument is based on a two-pronged approach.

The first is historical. Over long periods, 60/40 produces the goods. Highly applicable to many investors, particularly pension funds. Here the numbers look good on all measurements.

In the decade to the start of 2022, the classic 60/40 portfolio generated an impressive 11% annual return. Even after adjusting for inflation, its 8.7% annual real return stands up well, despite the low interest rate environment.

Critics would no doubt counter that 60/40 during the infamous 'lost decade' that began in the 2000s generated a paltry 2.3% annual return and investors lost value on an inflation-adjusted basis.

But the wider historic line overall can be said to hold and does so for an interlinked second reason. Looked at in historic terms, when 60/40 has had a bad period of time – as it did last year – it has typically bounced back to excel for a long period.

For example, 2022 was only the sixth year when a 60/40 portfolio fell by more than 10% and, on average, cumulative returns have been strong in the subsequent one, three and five year periods. Markets, it is often said, have a tendency to repeat history. Meaning that this could be the ideal time to jump fully in with 60/40.

Also, the result of the troublesome market for 60/40 was that valuations for the 60 segment asset classes are now lower, and most are fairly valued. The notable exception, analysts have observed, are US stocks, which are more reasonably priced. The point being this offers investors opportunities along the way.

Positive outlook

Plus, both parts of the 60/40 equation look attractive going forward in other ways. The 40 part is in a good place, with real return forecasts for most sovereign bonds moving into positive territory.

And for the first time since the global financial crisis, interest rates in most currencies have settled at or above the so-called 'cycle-neutral' rate – the rate that prevails on average over the long term.

And the focus has been that while equities tend to gain much of the attention within the 60/40 portfolio more of the improvement in some projections stem from fixed income, with expected returns more than two times higher than they were going into 2022. Based on this alone, far from being dead, the 60/40 portfolio could be poised for another strong decade.
For US 10-year bonds, the cycle-neutral yield rises 0.2 percentage points, to 3.2% in a forecast by JP Morgan. Much higher starting yields push its return forecast up by 1.6 percentage points to 4%, as a result.
Indeed, the 10-year US real yields are at their highest level since 2009, offering positive return prospects after inflation. "Major investment-grade bond markets are priced to deliver a return after inflation between 1.5% to 2% over the next decade," says Mike Coop, Morningstar's chief investment officer.

Positive picture

Looking at the 60 segment, the picture is also positive. Projected equity returns is one of sharp rises, with one forecast suggesting developed market equity will jump 3.6 percentage points to 8.4% [in dollars], and the emerging market equity forecast sees an increase of 3.2 percentage points to 10.1%. All together, these present telling arguments for 60/40.
Furthermore, modelling by Vanguard suggests 60/40 investors can reasonably expect anywhere between 2% and 5.4% a year during the next decade – down, it should be noted, from the impressive historic performance of 60/40, but still attractive returns for many investors.
In the same way, considering the improvements in equity and fixed income valuations, Morningstar valuation models suggest that the 60/40 portfolio stands to deliver a return after inflation of 3.6% during the next two decades, a 1.6% improvement from a year ago.
In addition, JP Morgan's long-term capital market assumptions forecast return for a dollar-denominated 60/40 stock-bond portfolio during the next 10 years is even more bullish, leaping from 4.3% last year to 7.2%. It's the highest projected return since 2010 and well above the rolling 10-year annualised realised average of 6.1%.
As with any investment strategy, nothing is simple. There is a variation to make 60/40 work, investors often need to tweak the portfolio at least once a year, to retain its roughly 60/40 balancing. How this is done depends on the investor. This action is, of course, rebalancing. In practical terms, it involves selling some outperforming assets and re-investing the proceeds in the underperforming ones, so that the mix of stocks and bonds remains 60/40.
This can be seen as playing a crucial part in the success of the 60/40 process – one that is not obvious at first sight. As the benefit here, is potentially psychological for the investors involved. Fluctuating markets can be a difficult place for investors, and rebalancing can give investors real peace of mind.

The next decade

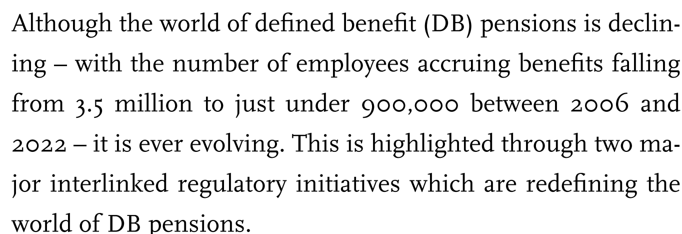
Looking at the picture for the next decade, there are other factors that play into the hands of 60/40. As the longer-term disinflationary forces of technology and globalisation may well slow – as is predicted – but they will still be dominant. And with such an environment this is highly supportive for projected returns rising substantially for both components of the 60/40.
Reflecting more on 60/40 in its component parts, with higher yields, bonds are once again a convincing source of income and a potential haven, both at the same time. And at lower valuations, equities are more attractive. The combination means that markets today offer the best potential long-term returns in more than a decade – something investors should plug into.
And the macro-economic outlook, far from stifling 60/40 could yet be another factor that boosts it. It is a somewhat paradoxical picture. For example, while inflation looks likely to moderate the underlying drivers of higher prices – shortages of important goods and commodities, so-called 'tightness' in labour markets, and growing geopolitical tension – are likely to remain risks for investors for the rest of the decade. Therefore, addressing these issues will likely require substantial, sensible and balanced investment, which fits with 60/40.
At the same time, going forward, after much market volatility, it could be the best environment in near on a decade for 60/40 related asset class returns – encouraging investors to focus on long-term portfolio goals within a potentially energized 60/40 approach.

A regime of higher volatility with sticky inflation needs a new approach to building tactical and strategic portfolios.

Jean Boivin, BlackRock Investment Institute

DEFINED BENEFIT: NEW RULES FOR NEW TIMES

Andrew Holt takes a deep dive into what two key pieces of regulation mean for defined benefit pension schemes.



Although the world of defined benefit (DB) pensions is declining – with the number of employees accruing benefits falling from 3.5 million to just under 900,000 between 2006 and 2022 – it is ever evolving. This is highlighted through two major interlinked regulatory initiatives which are redefining the world of DB pensions.

The first, dates back to last summer, when the Department for Work and Pensions (DWP) opened a consultation on the draft Occupational Pension Schemes Regulations 2023 which has deep ramifications. The regulations require trustees of defined benefit pension schemes to adopt a funding and investment strategy that sets out a strategy of low dependency for mature schemes. This means to minimise the potential for further employer contributions by being invested in low risk fixed income assets.

"The intention is to have better, and clearer, funding standards, but not to move away from the strengths of a flexible scheme specific approach," said the then minister for pensions Guy Opperman, when the consultation was launched.

But Matthew Arends, partner and head of UK retirement policy at Aon, questions whether this is the case. "While we support the overall objective of the draft regulations, we have major doubts over whether the proposed legislation is sufficiently flexible and whether the consequences of these potential changes have been properly addressed."

A point also highlighted by the trustees of Railpen in a written response to the proposals. "The draft regulations are more prescriptive than the existing funding regime, which we believe could exacerbate systemic risks to the UK economy," it read.

Before this hits the statute book, there remain concerns about the unintended consequences of the regulation. One is that the impact of the draft regulation will vary significantly between different schemes. "For some schemes, for example, those that are close to full funding on a buy-out basis, it may mean very little in practice," says Faye Jarvis, partner at law firm Macfarlanes.

Assuming, she notes, these schemes have appropriately de-risked, then they should have a limited dependency on the employer for future funding. "Therefore, the main impact is an increase in compliance as these schemes will still need to complete the statement of strategy and submit it to The Pensions Regulator (TPR)." This presents just one potential headache for DB schemes.

Tight deadline

However, for others, the implications could be numerous and varied. For example, if a scheme is close to significant maturity but is not invested on a 'low dependency' basis it may have to make substantial changes to its investment strategy over a relatively short timeframe. "The changes to its investment

For schemes that are already close to, or at significant maturity, it is not clear what the changes mean for them.

Faye Jarvis, Macfarlanes

strategy may also result in an increased demand for deficit repair contributions required from the employer," Jarvis adds.

Charles Cowling, chief actuary at consultancy Mercer, offers his assessment of the regulations. "It means we will see more schemes de-risking and heading towards eventual settlement.

"Schemes will have to target a low risk – 'low dependency' – funding, investment position which should have low or negligible reliance on the employer," he adds.

There is an impact here for schemes regarding their investment strategy that sets out their 'endgame'. "For those schemes targeting buyout as their endgame, they will need to consider what to do with their illiquid assets as schemes will need sufficient liquid assets to transact with insurers," Jarvis says. "Depending on where schemes are in their journey plan will determine how much of an issue their illiquid investments might be."

The new rules could trigger a rise in transactions on the secondaries market, as schemes look to sell-off such investments.

"For schemes that decide to run on, one of the key issues will be how to manage any surplus that arises in the scheme," Jarvis adds. "We are already starting to see schemes and their advisers come up with structures that will enable employers to access this surplus."

Power shift

On the back of the Occupational Pensions Scheme Regulations, the regulator is also consulting on a new code which outlines how schemes should best implement these new rules, the DB funding code.

David Fairs, TPR's executive director of regulatory policy, advice and analysis, sets out the regulator's objectives. "In line with DWP's draft regulations, our draft code is clear that all DB schemes should have the necessary long-term funding approach to ensure savers have the best chance of receiving the benefits they expect," he says.

"We want to provide schemes with the continued flexibility around funding to suit their circumstances, while requiring trustees to think carefully about risk management to improve security for their members," he adds.

The regulations and the code therefore introduce significant changes to the way DB schemes should be funded and, arguably, shift power more in favour of trustees.

This latter point is picked up by Jarvis. "There are some significant changes in relation to the trustees' assessment of employer covenant," she says. "The code is more prescriptive about how trustees should assess employer covenant strength.

"Trustees are expected to scrutinise management forecasts to understand the employer's prospects and available cashflow and the period over which the trustees can reasonably rely on that cashflow to be available," Jarvis adds.

Here, the extent of the information employers need to provide for the covenant assessment will depend on a number of factors, including the maturity of the scheme and its funding position. Some employers could find they are subject to more extensive information requests from trustees. "It should mean better funded schemes with lower risk and an increase in settlements and buyouts," Cowling says.

A costly move

A new single code of practice from TPR was expected to come into force this year but has been pushed back until April. The new code will require schemes to establish an effective system of governance and carry out an own-risk assessment.

Similar to the DWP, the focus of the TPR is on flexible change.

"We want to provide schemes with the continued flexibility around funding to suit their circumstances, while requiring trustees to think carefully about risk management in order to improve security for pension savers," Fairs says. "We will engage closely with the DWP and industry as we finalise the code after consultation."

There is an additional factor Jarvis has identified that will impact on DB schemes. "The new regulations and code will further increase the costs of administering a DB scheme," she says. "This, coupled with things like the more extensive information requests for covenant assessments and improved funding positions, may cause more employers to look at buyout as a serious option in the short-to-medium term."

This could, therefore, have big consequences for DB schemes.

Added all together the changes on the regulatory front amount to what could in fact be the lessons of last year's gilt crisis, and its severe impact on DB pensions, are being learnt fast. Or at least the crisis has speeded up thinking that has been taking place for some time within the DB scheme space.

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Emerging trends

The big question surrounding this is simple: are DB schemes up to speed with the changes that will hit them?

"For those schemes that are poorly funded and/or with weak covenants, potentially they will have a short period of time to get to 100% funding on a low dependency basis," Cowling says. This could be challenging for some.

"For all schemes, the events of last September and October – and the challenges with leveraged LDI – highlighted governance challenges and the fact that pension schemes are not always the best at the day-to-day monitoring of investments which can sometimes be needed," Cowling says, adding that even so called 'low risk' investment strategies still contain material risks that trustees need to manage to keep on top of.

The new rules are likely to trigger changes to investment strategies. "There will possibly be a greater use of cashflow-driven investment strategies and also more use of delegated investment mandates," Cowling says. "Over the longer term, there will be a big increase in insurance company buyouts."

The meaning of change

What is essential is that schemes should already be discussing the implications. "We would expect most schemes to have had some discussions with their advisers about the proposed changes to the funding regime and what they mean for their scheme," Jarvis says.

Although she adds confusion could also be a problem. "For schemes that are already close to, or at significant maturity, it is not clear what the changes mean for them."

Here Jarvis highlights something of an anomaly: the regulations and code do not address what schemes should do if they are already at significant maturity but do not have a low dependency funding and investment basis. "Hopefully, the final version of the regulations and/or the code will address this issue," she adds.

Cowling takes a different position, noting that the developments should, overall, be positive. "The move to lower risk investment strategies should be welcomed by members and trustees," he says, but warns: "There's still a huge amount of work to do to get the industry buyout ready, particularly with member administration data and legal due diligence."

Jarvis does though identify potentially troubling challenges ahead on two fronts. The first connected to potential risks of herding within matching assets. And the second could be even more problematic, echoing a point made by Railpen's trustees. "There could be the potential for systematic risks within gilt markets if lots of schemes want to sell gilts and there are no natural buyers," she says.

The move to lower risk investment strategies should be welcomed by members and trustees.

Charles Cowling, Mercer

Muddy waters

To add more complexity to the whole situation, the parallel Work and Pensions Select Committee inquiry into DB schemes raises several interesting questions on the future of such schemes. Its remit originally emanated from investigating DB schemes and the liability-driven investment debacle of last year, but has led to a wider look into the working of DB schemes.

This could be seen as muddying the waters of the DB debate, when it is trying to offer clarity. "It seems odd to have such an inquiry at the same time as the DWP and TPR are finalising significant changes to the funding regime for such schemes," Jarvis says.

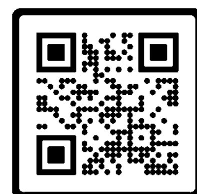
But Work and Pensions Committee chair Sir Stephen Timms said this was an appropriate time for such work. "Now is a good time to investigate whether the regulatory framework is set up to enable private sector DB schemes to continue to thrive under good governance and provide positive outcomes for scheme members. We will also examine the way DB schemes can be consolidated or bought out."

But with TPR confirming its DB Funding Code has been pushed back until April 2024 it puts the DB rules and regulatory picture in a potential state of flux. But Jarvis adds that a delay may not be a bad thing. "A delay would seem to make sense, given the inquiry," she says. "The issue of how to manage surplus in a DB scheme is topical at the moment."

On this issue, there are, she adds, steps that could be taken by government to make it easier to return a surplus to employers. "Something that perhaps should be considered, given the amount employers have had to pay into schemes in deficit repair contributions in more recent years."

So the DB pensions regulatory picture could take longer to resolve than anticipated. Or put another way: the new world for DB schemes could be only just beginning.

LOOKING TO STAY IN TUNE WITH INFLATION?



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DISCUSSION: EMERGING MARKETS

Favourable demographics and an abundance of natural resources mean that emerging markets (EM) are expected to outgrow the global economy this year at 3.7% compared to 2.9%, according to the IMF. With corporate earnings under pressure in the developed world, emerging economies look attractive, especially with central banks being further along their tightening cycle and China re-opening after axing its strict Covid restrictions. Yet there are issues. Eight countries in Asia are responsible for 45% of the world's greenhouse gas emissions, making them a huge ESG risk. So how are pension funds and insurers with net-zero commitments navigating these markets? *portfolio institutional* sat down with those investing in the emerging world to find out.

What do emerging market assets bring to portfolios?

Bola Tobun: Diversification and enhanced returns. It allows you to enjoy the growth of emerging market economies. But there is limited transparency on the ethics and governance of companies. The ESG credentials vary significantly in this region, making it difficult for us to increase its allocation.

Where are investors looking for quality, growth and value?

Nick Payne: Across the universe, there's always quality, there's always growth and there's always value.

India is popular in terms of growth and quality, and deservedly so. Investors like India because there is a long runway of multi-decade growth.

Other markets are more mature, so you will potentially look at value or dividend generation. There is something for everyone, because it is such a big, diverse universe.

Padmesh Shukla: EM is a promising story. In equities, the multiples are down 40% from their peak, on a relative basis versus the US. Fixed income is also interesting.

On ESG, we are investing in EM renewables. If we are lucky, we will probably make 7% in developed markets on a good day. There is a clear narrative around EM and infrastructure, but there is a spectrum in terms of quality, the political system and stability. You have to be careful where you are fishing.

I'm quite bullish on EM. Asia, as always, offers the most interesting opportunity set, followed by Latin America and then there is Africa and its urbanisation story that is not even a footnote in our portfolios today. Looking ahead five to 10 years, it is a diverse and interesting opportunity set.

What is Border to Coast's emerging market investment strategy?

Will Ballard: Focusing on the equity part, we have done something a little unusual. China dominates when people are looking to invest in emerging markets, so we have separated the mandate into China and emerging market ex-China.

When allocating capital, you have to look at it over five, 10, 20 years and we see China being a dominant force within emerging markets, so to manage that we have separated it.

If you are looking at emerging markets ex-China, Brazil becomes more relevant. Brazil was quick to raise interest rates and they could be starting to come down, while inflation is more under control.

You start to think more about your local allocations and the smaller markets start to become more relevant. It gives you an opportunity to delve down to find better opportunities.

Vanessa, what investment ideas have you had from looking at emerging markets?

Vanessa Zhao: A lot of interest has been in China's growth stocks, which are quality companies with good fundamentals and promising growth trajectories. But in the past three or four years, non-fundamental elements are affecting China, like geopolitical risks and trading bans from the US. Within China itself, there is a lot of policy reform. Common prosperity is affecting the education sector, healthcare and automation. We watch policy within the country closely because it changes where we play in the long run.

We tend to focus on quality players that have a tailwind from local or central governments and less exposure to those non-fundamental elements. These are in areas like carbon neutralisations, automation and semi-conductors.

Oriana, what do your clients want to know about emerging markets?

Oriana Mezini: We often get questions around active versus passive. For gaining exposure to emerging markets, we believe in active management. These markets are less efficient so there's more opportunity for alpha. Governance is an important issue as is geopolitics, so we prefer active managers. I assess asset managers and their investment processes. They must have ESG integrated into their investment decision making. It is a must, not just in emerging markets, but across the whole spectrum.

If you have a remit to cut emissions from your portfolio and you want emerging market exposure, do you have to go active?

Lorant Porkolab: We have seen a significant growth in ESG index-based strategies focusing on emerging markets. Somewhat simplistically, if an ESG index excludes brown companies with weak environmental credentials or the bad boys not willing to comply with common ESG disclosures and standards, then by going passive you can achieve a considerable positive ESG tilt in your portfolio at a reasonable cost. But is this passive investment or an active one in disguise? Of course, this passive approach is far from perfect, and the closer stewardship and engagement by an active manager can deliver more substantial ESG benefits in the long term.

Shukla: Bad boys is an unhelpful label. Risk perception matters in EM markets

India will not be the new China.

Will Ballard
Head of equities
Border to Coast

for trustees and I would be careful how we define some of these companies, which are in an index for a reason. We invest in EM commodity exporters because without their products there is no net-zero transition.

The G should be an important focus of ESG analysis because a well-governed company will probably be a well-engaged company. We have to work on and look beyond perceptions as investors build lasting and generic high-risk premiums and mental barriers live on the back off few bad experiences – Argentina, for example.

Tobun: It depends on the manager. The carbon exposure of London CIV's emerging market portfolio was high as the manager invested heavily in carbon-intensive companies.

When this manager was changed due to performance issues, the portfolio's carbon exposure reduced significantly. This is because the new manager incorporated their in-house philosophy into the mandate. And the incumbent manager delivered better performance than the previous manager.

This demonstrated that one can incorporate the desired ESG criteria and still earn a better risk-adjusted return.

Ballard: We are talking more and more these days about the difference between greening the world and greening your portfolio. This is not just an emerging market issue.

Anglo American, for example, has improved its green credentials by making a commitment, under guidance from their shareholders, to exit thermal coal. They spun out these assets by listing Thungela on the stock market. The portfolios which hold Anglo American have become greener as their carbon footprint has reduced, but Thungela is still producing thermal coal and has a similar carbon footprint.

Tobun: You must remember the need of scheme members, which is not just about making the world a better place, as important this is. At the end of the day, the primary objective of the fund is to have enough money to pay pensions as they fall due. This can be a difficult balancing act for the trustees.

Zhao: In emerging markets, active managers are a better choice for investors than a passive ESG index. There are a couple of important issues. One is the quality of ESG ratings, which are not comprehensive or consistent.

When I started as an analyst 13 years ago there were only a handful of funds that did ESG analysis and engagement. But the methodologies they used were different. The third party ESG analysis providers spoke to companies approximately every two years.

Things may have improved in that they have hired more people and speak with companies more regularly. But a score can stay outdated with companies being punished for events that happened five or six years ago.

Another issue is now that ESG is popular and attracts a lot of capital, funds have developed their own ESG methodology and scores, which are not consistent across the industry either.

But companies are improving their disclosures as ESG has become more and more important for investors and regulators. For example, there is a famous internet company I engaged with 13 years ago, which is now completely different in that they have a dedicated ESG team working on their disclosures.

You can only find these details from many companies through good long-term direct engagement. If you only read a Sustainalytics or MSCI ESG report, it may not include all the improvement in details, and can potentially lead to exclusion.

Payne: Our experience echoes that. We are always careful in recommending anyone to buy a passive ESG product because you are effectively contracting out a huge part of the investment decision. You would be shocked at the level of basic errors in those providers, such as which sector a company is classified in. They have one analyst covering hundreds of stocks and not in any great depth.

If you buy a passive product, you are effectively sub-contracting that position out. You have no influence, whereas an active manager does.

Also, it is a myth that in emerging markets ESG is more challenging. The reality is that they are not as good at reporting it. We often find, particularly when talking to smaller companies, that the better gov-

erned companies are more advanced in either doing it or willing to listen. They ask us what they need to report on, they are taking action and mapping things out. But because it is not mapped in a way that Sustainalytics or MSCI wants to see it, they are making a reporting error.

We have found it valuable to guide them on what milestones and roadmaps investors want to see.

Shukla: It is important not to have a blanket view of these things. The most bang for your buck from emerging market companies comes out of engagement. It is not that they don't want to do it, it is trying to understand what the protocol and process is.

You lose that if you decide to leave the table by not investing because the ESG score happens to be poor. It reinforces the point that active management is important and engagement is super important part of that process.

Ballard: We have done a lot of work on this. There appears to be a correlation between the size of a company and its ESG score as well as the number of interactions it has with the ESG rating agency. That tells me two things. Firstly, companies need more guidance on what ratings agencies want to see and how it needs to be presented. Secondly, the ratings agencies are looking at thousands of data points, so unless you are a huge organisation with an incredibly well-staffed investor relations team, it is hard for you to provide all the data needed.

Tobun: Fund managers need institutions like the credit rating agencies to create an ESG standard template to enable us to have comparable measures. Currently, there is no credibility or consistency in the ESG data we are receiving.

Payne: You could go the other way. In this space, there is a desire for false precision. Everybody likes a label, everyone likes AAA, BB, CC, but in the real world analysing and owning companies is not like that. There are grey areas about countries, geopolitics and companies' interpretations of goals, but everyone is driven by a desire to stick a AAA label on it and off we go.

Porkolab: There is a huge oversimplification in a single ESG score when there are hundreds of factors to consider. There is no consistency or standardisation, and aggregating, for instance, climate and social factors by washing them together can easily hide important characteristics.

China is now a consumption-driven economy and India will go down that path.

Nick Payne
Investment manager, global emerging market equities
Jupiter Asset Management

Credibility and reliability are also important considerations. Who is auditing the information? Who is checking and confirming the metrics? Are we just taking them at face value?

Ballard: There is movement. On carbon footprints, for example, there are standards. It is happening, but it is the beginning.

Shukla: Everyone knows what we expect from a company when it comes to the E in ESG. The question is whether it's being measured and reported in a timely and accurate manner?

On governance, most people understand what it means to be a well-governed company. But each country has its socio-cultural context and practices, which means they will be slightly behind, or may take a different slant on governance than what a classic Anglo Saxon model may profess.

On the S, where do we start? What is acceptable in our home market might be outdated in Sweden, for example. That to me is the hardest part and is where most of the debate tends to happen.

Porkolab: In principle, there is no significant difference between emerging markets and developed markets when considering ESG factors. But in some of these areas, in particular those related to social or governance issues, the reasons for weaker or different ESG credentials of emerging market companies could lie deeper and are related to political or cultural factors. Developing an understanding of these factors and how they may develop over time is equally important from the perspective of an investor based in a developed market.

Even with engagement, making a significant and relatively quick improvement in the S and G areas when investing in companies in China or India is far more challenging than in Germany or the US.

Shukla: But in developed markets there are countries equally challenged on this. The diversity of the E, S and G practices between Italy and Sweden, for example, may probably be the same as between the UK and India.

If you do not invest in emerging markets, then you do not have the influence to force positive change.

Oriana Mezini
Senior investment research consultant
Hymans Robertson

Porkolab: When it comes to pension schemes, trustees need to consider their fiduciary responsibilities, namely of what pension scheme members may expect from them regarding investment decisions, including those in emerging market companies.

Trustees have to decide if they can and want to accept these cultural differences, potentially resulting in lower ESG scores, or exclude such companies or countries from their investment portfolios, which could reduce the diversification benefits and potential returns.

Zhao: It is difficult to compare the ESG practices of an emerging market company with those of a counterpart in the developed world. If you compare them based on a UK, US or European framework, then you may find emerging market companies score much lower. I wonder whether it would also be helpful to only compare the ESG practices of emerging market companies with emerging market companies, as one reference point to indicate the ESG progress in emerging markets over the years.

Another issue to consider is how a company's ESG practices have evolved because emerging markets have changed so much. China today is different from China 15 years ago. How many companies have become giants during that time, like

We have learned to live with these variations in western markets. This is another example of how labelling is unhelpful as differences exist everywhere.

Porkolab: It is fair to say that the variation regarding ESG credentials in emerging markets is significantly higher than in the developed universe. Therefore, there are more challenges when it comes to reporting, engaging and making change happen.

I am not saying this is a reason not to invest, but we have to recognise that emerging markets are a less homogeneous universe. We have to be a long-term patient investor and cope with these challenges.

Payne: Otherwise, we end up looking through a UK-centric lens. We get recommendations to vote against directors who have been on a board for 15 years, but they have been on the board for 15 years because it's culturally normal in India.

Then there are instances where we have been asked to vote against something we believe is sensible. For example, we had a Brazilian company that was making a transition from the original owners to professional management. They offered a 10-year remuneration glidepath, which we thought was excellent, but we were asked to vote against that because it was too long.

Porkolab: Is this a fundamental question or problem in the way we look at these things, in particular ESG factors? Namely, assessing them from a UK or European investor perspective and evaluating them through that lens?

Payne: If we use a UK or European framework when looking at a company in India or China, we can all understand the relevance of rotating boards and explain that to those companies. But they often come back with it being a good idea to have someone with 20 years of industry experience on the board to give them a view of what it is like in good times and bad.

There is a huge oversimplification in a single ESG score when there are hundreds of factors to consider.

Lorant Porkolab
Trustee director
Law Debenture

Alibaba? Assessing a company's ESG practices over time can be helpful.

Porkolab: This is a valid point, but if we apply different standards and criteria in different territories, then we lose some objectivity. If we give up using a consistent methodology for comparing emerging market companies with those in developed markets, whether it's for ESG or other factors, are we not compromising too much and risking of making sub-optimal investment choices and decisions? Are we saying that Vietnamese companies should only be benchmarked against Vietnamese companies?

Ballard: There are clear differences when it comes to government requirements. When assessing a company, it is not wrong to start with what you believe to be the best possible standards, which may not necessarily be in your personal geography. But you must acknowledge any difference, know why that gap exists and understand the direction of travel.

Mezini: If you do not invest in emerging markets, then you do not have the influence to force positive change.

Ballard: Exactly. It comes back to Bola's point about the perception that investing in emerging markets is a greater risk. That could be true, but I'm not sure because there are lots of risks in developed markets.

Shukla: We have talked a lot about ESG, but I am keen to understand why we allocate to EM because there is a higher hurdle in terms of understanding these markets. For all this extra pain, there has to be extra reward. But ESG has moved the hurdle higher for institutional investors to allocate capital.

Tobun: ESG is not the only consideration, but it is a major factor nowadays. People tended to ignore it, but now there are pressure groups and lawsuits out there for companies that are behaving badly, so ESG integration into investment philosophy has to be a priority.

Local government pension schemes see ESG as a reputational risk, so we try to ensure we don't get negative publicity by investing in organisations with bad ethics.

The most bang for your buck from emerging market companies comes out of engagement.

Padmesh Shukla
Chief investment officer
Transport for London Pension Fund

Porkolab: I don't disagree, but, from a fiduciary responsibility point of view, there are more than ESG factors to consider when making investment decisions on behalf of scheme members.

The big question is whether the primary focus should be on financial considerations, because that's what matters when it comes to paying members' pensions, or if the non-financial considerations should receive an equal weight, as these will make the world a better place and may also affect the outcome for members in the long run?

Payne: We mostly get feedback on diversification and growth.

On diversification, the correlation of the European markets with the S&P500 has been around 0.8 over the past two decades. Most emerging markets are 0.5 lower, with some a little higher, like Taiwan, due to the inter-connected nature of electronics, and Hong Kong because of the dollar peg. Individual markets like Colombia, Saudi Arabia and Indonesia are around 0.3.

That brings us to growth. A lot of investors equate that faster GDP growth automatically turns into faster earnings growth, which automatically turns into higher share prices. It doesn't. The problem is many people have not realised that turning a growth environment, like India and Indonesia, into return per share, return on capital or return on equity is challenging.

We look at three quarters of the emerging universe and it does not beat a 10% cost of capital, which is a reasonable hurdle.

That exists for a couple of reasons. It's the structural makeup of the indices as there are more commodity markets. Oil companies and miners are not high return on capital businesses, they are price taking businesses which are dependent on the price of iron ore. It is the same in developed markets but the allocation in EM indices is higher than in Europe and the US.

The other reason is shareholder capitalism. The US is one of the world's best performing markets, even though its economy is growing at 2% or 3%, because companies turn growth into a higher return on equity. They are focused on shareholder value, not getting big for the sake of being big.

Shukla: Does this lead you to a certain style if you want to hit 10% because everything is either state owned, family owned or a combination thereof, leaving only a small subset?

Payne: That is why you should buy quality businesses. There is a higher component of state-owned enterprises in emerging markets, which is why we exclude oil companies because you cannot engage with them. The state is only interested in maximising the profitability of the geological gift they have been given.

The universe will look the way it does until shareholders get more demanding in asking for management to grow a sustainable business and maximise returns.

We often find that this is secondary or tertiary as an objective. It is rare that we meet management teams who understand what return on invested capital is.

Shukla: If I compare the index today versus 10 years ago, it is much more dynamic with new economy companies. There is so much more to choose from compared to 10 or 20 years ago.

Ballard: What was interesting is that you gave two options: value or growth, and Nick picked quality. That speaks quite strongly to what is going on in emerging markets, which is you don't want the state-owned enterprises, you don't necessarily want the highest growth companies, you want the companies which can consistently deliver high returns. They have strong brands and can generate high sustainable returns over the long run.

Payne: That is the best way of capturing that GDP growth.

Ballard: This is different from the previous perception, which was: go to emerging markets purely for growth.

There is a little more maturity now. Growth is slowing in emerging markets and there is volatility, so we need to invest in companies that can survive the tough times and come out stronger. It's about persistence.

Could we go back to China? What impact will the end of the zero-Covid restrictions make?

Zhao: China had a different approach to Covid. It was strict in the beginning and then they civilized the situation while the West opened up. China was catching up, but by the beginning of this year, around 80% of the country was infected.

Now they have recovered. In Q1 people returned to work and resumed other activities. In Q2, domestic traffic is almost at the pre-Covid level, but consumption needs to catch up.

The government wants to see how the re-opening will play out by itself without big monetary stimulus but has kept some tools behind in case the economy needs a boost. What happens next will be interesting. The re-opening effect will last for maybe three quarters but what will then sustain and support the recovery and drive company revenue growth.

Shukla: It looks like China is becoming a binary issue. There is strong economic case, but because of the geopolitical concerns, should we invest or not?

Zhao: Apart from the fundamentals, in the past 18 to 24 months, you see people discount China based on geopolitical concerns like the relationship with the US and the news around Taiwan. That will not be completely removed anytime soon.

Porkolab: The removal of the zero-Covid restrictions will have a considerable positive impact, just as introducing them had a negative impact.

The binary point regarding investment in China mentioned earlier is interesting. No doubt, there are lots of companies with great potentials in China, but how do you overlay and factor in the considerable geopolitical risk?

Similarly, some would argue that certain country specific ESG factors, such as human rights issues, should also affect your view of how much you allocate to China, especially if you have carved it out of the EM universe.

Ballard: Questions around a discount are almost impossible to answer. What you can look at is the revenue being generated in China, which is lower than in 2018. Earnings are incredibly depressed as well. There is a lot of capacity out there and when things pick up, you do not necessarily need to invest more capital to grow. The operational leverage which could come through is significant.

Valuation does not necessarily give you a trigger point to get into something, but it can give you a measure of the additional returns you could get when economic activity picks up.

It is difficult to compare the ESG practices of an emerging market company with those of a counterpart in the developed world.

Vanessa Zhao
Portfolio manager
Candriam

Payne: There is a huge margin of safety in China. To put this into context, Ping An, China's largest privately owned insurer, traded on 10 times earnings prior to Covid. Today, it is on around five times. The question for us is, will it return to 10 times earnings, or, because of geopolitics, is it now an eight times multiple stock in the medium term?

It is undervalued and earnings are depressed, so there is plenty of runway to make attractive returns. The medium-term question is, do we put a 10 or a 20 on it and how do we quantify that discount because China may or may not be getting a more difficult place to invest because of President Xi's attitude to private businesses.

To what extent does the desire for more control compress free market entrepreneurialism. Xi has reiterated his support for the private sector because it is 80% of jobs in China. The new model coming out is of common prosperity: don't be an island with your wealth. Get rich but share.

Shukla: A lot of institutional money is looking for a credible home. With China's geopolitical risks, could and should India be the new China as the next big destination for global institutional capital? It is democratic and there is attractive demographic story.

Mezini: The macro is important, but it is about investing in those companies being run in the best interests of its shareholders, especially from the perspective of a foreign investor. These are some of the factors that active managers consider when selecting companies to invest in whether India or elsewhere in EM.

Porkolab: All the positive developments in China happened while we were going through a strong globalisation stage. This has changed, and we are seeing much stronger anti-globalisation trends and political mindsets across the globe, and this may also affect the way forward for India in terms of economic developments compared to China in the previous decades.

There is no credibility or consistency in the ESG data we are receiving.

Bola Tobun
Treasury and pensions manager
London Borough of Harrow

Ballard: What you say is true. The world is not where it was when China joined the World Trade Organisation. The journey they took to become the manufacturing engine of the world – bringing in low cost labour, producing goods that people did not know they wanted at incredibly low prices and the proliferation of global supply chains – cannot be done again.

We are now seeing onshoring. People are worried about who they are relying on to get their goods. They are thinking about how to automate production at home. Perhaps we are in a different phase when it comes to the global economy.

I am not saying the Chinese model is necessarily dead, but I wonder whether we are at a stage where going through that journey again is not possible. It has to be a different journey.

Payne: India is a deep, rich market of investment opportunity. The current administration is reaping the benefits of the reforms they sowed a few years ago – like the goods and service tax – which were quite painful and politically unpopular.

India has had a big drive on digitalisation and a credible central bank with strong institutions and rule of law. But it is not an easy place to invest as it is idiosyncratic and has world-class bureaucracy.

It is India's to lose. In other words, it requires a huge global shock, such as an oil price spike or their politicians to mess it up.

Shukla: It is quite an inward focused, consumption driven market. That is where the diversification story comes in with it not being entirely dependent on exports.

Ballard: India will not be the new China. India will always be India and it will have a different development path.

Shukla: If globalisation has peaked and economies become more inward looking, then that is generally bad for emerging markets, particularly the ones with a strong goods export tilt.

Payne: That is bad for different countries. Will is right: the 2000 and 2010 decade is not going to be repeated and nether is the Chinese model of building bridges to nowhere. China is now a consumption-driven economy and India will go down that same path.

pi ESG CLUB

Climate change is not the only threat to humanity. Covid highlighted the damage a health crisis can cause to society. With chronic illnesses on the rise and bacteria proving too strong for medicines, this month's ESG Club looks at how we can avoid another pandemic.

Members

BlackRock

INVESTORS PUSH FOR GREATER WORKFORCE ENGAGEMENT IN THE BOARDROOM

Eight major investors are behind an initiative to get more people from the shop floor into the boardroom. *Andrew Holt* looks at what this could mean.

The E has dominated many of the ESG initiatives that have been introduced into the investment world, but there is now a strong push to move the S and the G into the spotlight.

Railpen, together with seven other institutional investors, has launched an initiative to encourage companies to include the voice of their rank and file workers at board level.

This guidance for appointing workforce directors, as well as exploring worker voice mechanisms, provides insights into 'what good looks like' regarding the role, recruitment and retention.

The initiative was created in response to requests from some of Railpen's portfolio companies for the investor perspective on members of the workforce joining the board.

It incorporates feedback from discussions with companies, investors, regulators, workforce representatives and academics, as to how companies can approach appointing one or more directors from the broader workforce.

A workforce director is a director drawn from the company's wider workforce or employee base. Interestingly, Railpen's definition does not consider the workforce director to be a representative of the workforce. Rather, they have the same fiduciary duties and stakeholders to consider as any other director, but they are also part of the firm's broader workforce.

Caroline Escott, senior investment manager at Railpen, explained the rationale behind this. "They become a director, in the same way as any other director. We are trying to avoid creating a two-tier or segregated approach to companies, where the workforce director is only considered to be able to contribute to a particular set of issues.

"In fact, while that broader workforce perspective is useful, it is useful across a range of issues: everything from remuneration to broader business strategy," she added.

A material world

Railpen, and others from the investor group, will engage with companies and their asset managers, where it believes there is merit in considering or raising the issue of workforce directors. It will also work with policymakers where improvements can be made to create a supportive regulatory environment.

Furthermore, the guidance draws upon evidence which reveals that there are two main benefits for companies and investors from appointing one or more workforce directors.

First, potential improvements to the cognitive diversity of a board, providing a particularly valuable perspective, with diverse boards more likely to make informed and effective decisions.

Second, it is helping workers to feel their voice is heard and acted upon. This could see them become more engaged and motivated which in turn are, as Escott has said, 'financially material' benefits for company performance.

Railpen's guidance also draws upon research showing that workforce directors are most effective as part of a broader, coherent and intentional approach to workforce engagement and alongside other mechanisms. The scheme has stressed investors are keen to understand how the worker perspective is intentionally included in strategic decision-making at their portfolio companies because, the pension fund says, a fulfilled, engaged, and motivated workforce is important to the long-term, sustainable financial performance of a business.

Power to the people

Other signatories to the officially titled: *Workforce Directors Investment Statement*, include Border to Coast, Brunel Pension Partnership, the Church of England Pension Board, Merseyside Pension Fund, USS, Rathbone Greenbank Investments and Royal London Asset Management.

"Fulfilled, engaged and empowered workers are fundamental to the long-term success of companies," Escott said. "The Covid-19 pandemic and the subsequent 'great resignation' have highlighted how important it is that a company's most senior leaders genuinely consider and respond to the perspective of the wider workforce."

She added that while the investor group do not think there is a single 'right' way for firms to engage the workforce, "more companies should at least consider the merits of appointing a workforce director to the board – such as the potential improvements to cognitive diversity.

"We hope our guidance provides some helpful considerations and insights into what we think is an underexplored workforce engagement mechanism and welcome the opportunity for open and collaborative conversations with all those keen to ensure the worker voice is effectively heard," Escott said.

Bruce Jackson, senior responsible investment analyst at USS, added that the pension fund is 'delighted' to support the initiative. "This will provide company boards with meaningful suggestions to enhance workforce engagement and consider appointing workforce directors to their boards," he said.

USS has workforce directors on the board, appointed by University and College Union, a trade union. Jackson added that while USS recognise this may not be suitable for all companies, the inclusion of workforce perspectives at board level can align the interests of shareholders, management and workers over the long term. "It can also provide valuable insight into company operations to improve strategic decision making."

INTERVIEW – CAROLINE ESCOTT

"We see opposition to ESG as a spur to work even harder at getting that message out."

Railpen's senior investment manager tells *Andrew Holt* about the importance of voting, focusing on the big picture, dealing with cynics and standing on the shoulders of giants.

Why has Railpen helped create an initiative to get workers heard at board level?

Well, a few things came together. Firstly, there is a growing body of evidence that an engaged, fulfilled and motivated workforce that feels listened to is important for long-term financial success. And that matters to us as investors.

The second piece was that even though we recognise there are many useful workforce engagement mechanisms out there, we at Railpen have, for some time, thought workforce directors are underutilised amongst companies.

We see for ourselves, with our own trustee board, the benefit of cognitive diversity that comes from having that broader perspective.

We also recognise there are examples of the positive impact workforce directors have had on the running of a company and on strategic decision making.

We have worked with companies, investors, academics and workforce representatives to pull together some guidance that we hope will offer more clarity to companies who are thinking about this.

What is this initiative's ultimate goal?

There are two objectives. The first is for those companies that are already thinking about this, to give them some clarity, some food for thought. It pulls it all together for them, with the evidence demonstrating that under what circumstances workforce directors might be helpful.

But it is also to encourage companies who aren't thinking about workforce directors as an employee engagement mechanism to get over some of the misperceptions and have a proper look.

What are those misperceptions?

There are concerns that organisations will not be able to find someone with the necessary skill set. But the evidence shows that with the right training, the right support and an inclusive board level environment, workforce directors add a valuable perspective.

This focuses on the S and the G. How important is ESG overall to Railpen?

Railpen has been active on what we call sustainable ownership for a long time. We were one of the first pension schemes to publish a global voting policy and to have in-depth corporate governance policies. And we have been building on that over the years.

Given our long-term horizons, sustainable ownership is absolutely fundamental to protecting and enhancing value for beneficiaries. So we do it at the core.

When did you first approach it that way?

We published our first global voting policy in 1992. I remember 1992. There were luminaries like Frank Curtis and Deborah Gilshan, who were our industry titans.

I use this phrase a lot, but [Railpen's] sustainable ownership team feels that we are standing on the shoulders of giants.

Why does your sustainable ownership team work on three areas: integration, stewardship and the climate transition?

We work closely together across our teams. ESG is integrated within the ownership and climate work stream. It is all about stewardship and the integration of climate change and financial analysis.

That being said, ESG integration is about incorporating financially material sustainability considerations into our investment analysis and decision making. Active ownership is thinking about how we use that information to influence the companies we invest in to improve their corporate behaviour.

On financial materiality, the climate work stream is looking at doing it through a clear-eyed understanding of the key emitters in our portfolio. Then thinking thoughtfully about how, and where, to engage with these companies to achieve real world impact on climate change.

What percentage of your assets are held in ESG investments?

We look to incorporate or address financially material ESG issues across all our portfolio. We look at ESG holistically and try to incorporate it across all asset classes.

Our portfolio has £34bn of assets and we try to look at ESG, in different ways, across all of it.

There are holdings we engage on and do a bottom up analysis of. We also think about big picture ESG themes: climate change, biodiversity or workforce issues that affect our whole portfolio, or a substantial chunk of it. Then we have long-term infrastructure investments, focused on things like the mental health facility we are supporting in Sunderland.

Which is the most important element in your ESG approach?

Leadership. It is fundamental to creating long-term value for beneficiaries.

We consider all ESG issues and we have a clear focus on financial materiality. We look at ESG issues that are thematic in the portfolio and at the bottom up level, which we believe are most likely to impact the long-term financial performance of a particular asset or a company.

You also use your ESG approach to steer your votes at AGMs. How successful has that been?

We consider company performance on, again, financial materiality as well as environmental, social and governance considerations, when we cast our vote.

This is often, and importantly, aligned to engagement. There is a steep spectrum of stewardship tools and engagement sets. At one end of it is voting and ownership rights, with divestment at the other.

For us, most of the impact is when you align your voting with your engagement and use that as part of a stewardship strategy, with an understanding of the objective that you are trying to achieve. We use that approach across our major holdings.

I would say that it has had some positive impact in the few years we have been engaged with these companies. Of course, with some of them we have longer-term relationships.

Can you shift the ESG dial on companies through voting alone?

It is possible to have an impact. We see that through some of the activities and changes in corporate behaviour that have happened as a result.

Voting is an important stewardship tool. It is a public expression of shareholder dissatisfaction with the company, or support for its behaviour on certain key issues.

I would say that it is most impactful when aligned to a broader stewardship strategy, which can include engagement.

I will also say that it's more impactful when investors think not just about voting on a generic resolution, but where they are particularly unhappy with a company's behaviour and vote against the individual director that they deemed responsible. That is something we try to do at Railpen.

Voting season is an important opportunity for influence. You get to exercise your vote and companies are incentivised to meet with you before and after the vote.

That's a good opportunity to reinforce relationships and with it, progress on those issues.

Are there any times when you consider divestment as an option?

We have a number of exclusion processes. We have a climate exclusion process where we exclude companies from our portfolio if they have a certain proportion of revenue deriving from things like oil sands.

We also have a cluster munitions exclusion process. And we have what we call a governance and conduct zero weight exclusions process, which we have been building upon in the past few years. This is about those companies where there is either a conduct issue, or where there are many governance red flags.

And there is the case when we engage with a company and they do not feel like they recognise there is an issue or they are not truly committed to improving their governance.

What other ESG aspects do you look at?

There is the big picture, the top down, systemic level of issues that face our portfolio. And for that, we have some major themes. There is, of course, the climate transition.

Then there's the workforce, looking at a number of different workplace issues, like worker engagement. We have also been doing quite a lot of work on workforce disclosure. Workforce human capital is an area where the quality of disclosure from companies is highly variable. It is material. Something needs to be done to change it.

Also technology: thinking about issues like cyber security or content moderation governance that impact some of the large media and tech firms.

And then there are sustainable financial markets. And within that, because sustainable financial markets could cover quite a big piece, quite a huge suite of things. Our work is focused on things like unequal voting rights through the Investor Coalition for Equal Votes.

As asset owners, we sit at a privileged part of the investment chain.

And from next year, we are also going to be doing some more work on audit – and the quality of audit.

How would you rate how the investment industry has dealt with ESG?

We are all on a journey. Some of us maybe started a bit earlier on the journey than others. But even in the 10 to 15 years I have been in the industry, the level of support for ESG has grown exponentially amongst asset managers, asset owners and policymakers. So that is positive.

Are asset owners and asset managers on the same page in terms of the importance of ESG?

Asset owners are becoming increasingly demanding of clients on ESG. That is positive.

Asset managers have, for instance, collaborative, open engagement processes. We at Railpen work closely on a number of ESG-related issues with them.

Are governments and supranationals doing enough to address ESG issues?

It has a positive groundswell of support and action. We have seen that at the UK government level. We have also seen it at the supranational level. A lot of the debates being had are the right ones. We do need more co-ordination internationally in order to avoid regulatory arbitrage, because investors are global.

How do you view the backlash ESG is facing from some quarters?

There have always been individuals and groups that are naturally sceptical about responsible investment and sustainable ownership.

We survey our members specifically on sustainable ownership.

While there are lots of supportive comments on particular issues, there are also comments around: 'I don't want you to do good, I just want you to make as much money as possible'.

Our consideration of sustainable ownership is as something that's financial material, something that has an impact on the bottom line.

The way we deal with it is to emphasise, in our communications to members and in our other external reporting, the materiality of environmental, social and governance issues to particular investments.

We provide case studies to support this. We even pull together a concise summary of some of the available evidence on the financial materiality of ESG issues.

So we see opposition to ESG as a spur to work even harder at getting that message out.

What are your ESG challenges going forward?

It's boring, but it's important, and that is the need for clear, consistent, comparable data. Making sure we have the data points we need.

The other point is: it's been great to see asset owners acting as demanding clients in this and building their stewardship teams.

But we need to continue the scrutiny and the pressure all the way down the investment chain.

As asset owners, we sit at a privileged part of the investment chain. We have the commercial influence to be able to pull up, and through good stewardship and responsible investment practices, all parts, all the way through to the ultimate benefit of members and savers.

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HEALTHCARE – DIAGNOSIS: BAD

Covid, diabetes, dementia, ageing populations and antibiotics that don't work – the health crisis is up there with climate change, finds *Mark Dunne.*

Miracles come in many forms. The latest miracle to sweep the western world comes in the shape of a tablet or can be found within a medicine bottle. Semaglutide is a daily injection that helps people lose weight by reducing their appetite. It is one of many weight-loss drugs to hit the market.

Elon Musk and Jeremy Clarkson have admitted to using such treatments while games are played online to unmask the celebrities who have joined them.

But this is not just about vanity. Semaglutide is available on the NHS. Developed world governments are allocating more of their tax income to healthcare while their GDP is taking a hit from lower productivity as people slip out of the workforce on medical grounds.

Obesity is one factor behind a range of chronic illnesses including cancer and diabetes. Another major demand on the care system is the increasingly ageing population.

If an example is needed of the demand and destruction that a healthcare crisis can cause, just look at Covid.

Covid was more than a pandemic. It was a crisis on par with a war. It put companies into bankruptcy court, destroyed economies and took our nearest and dearest from us. If it happened again, would we manage it better?

"The world is certainly more sensitised to what it takes to manage a pandemic," says Steven Slaughter, a portfolio manager in the intrinsic value team at Manulife Investment Management. He adds that Covid has left people with a "better focus on and appreciation for their health, the health of their families and the health of their co-workers".

Yet there are potential healthcare crises that could rival Covid in terms of the number of lives it claims.

The drugs don't work

HIV and cancer have for decades been names that people do not want to hear when speaking with a doctor. Well, there is another condition that has joined them in that it kills millions of people every year: antimicrobial resistance.

This is where bacteria evolve to a point where medicines, such as antibiotics, do not kill them anymore. It means that people could die from something as trivial as a grazed knee. This is already happening.

In 2019, more than 1.2 million deaths were directly attributed to the condition, meaning that it killed more people than HIV or breast cancer. If its wider impact is considered, bacterial infections are responsible for a similar number of fatalities as Covid.

There were 6.8 million Covid deaths over three years, according to John Hopkins University, while there were 4.9 million indirect deaths attributed to antimicrobial resistance in 2019 alone. This is based on estimates from the Global Research on Antimicrobial Resistance Project.

The situation is only expected to get worse. An independent review in 2016 by Lord O'Neill concluded that not addressing this issue could lead to 10 million deaths globally each year by 2050. Maria Ortino, a global ESG manager at Legal & General Investment Management, says that antimicrobial resistance undermines how we look at modern medicine. "We will not be able to perform even standard surgery if we do not have antibiotics.

"We would highlight antimicrobial resistance as a systemic risk equivalent to climate change," she adds. "We need to deal with antimicrobial resistance, otherwise we might not be around to deal with anything else."

There are other impacts for people to consider if they believe they are healthy enough to survive dying from a grazed knee. In 2016, the World Bank analysed the economic impact of superbugs, which are strains of bacteria, viruses, parasites and fungi that are resistant to most antibiotics. The Bank estimated that if we do not do anything about the issue, around 3.8% will be wiped off the global economy. "That is equivalent to what we saw in the 2008-2009 financial crisis," Ortino says.

This translates into global output losses amounting to more than $1trn (£800bn) a year after 2030, rising to $2trn (£1.6trn) by 2050, the World Bank estimates.

In the worst case scenario, $1.2trn (£961bn) of additional healthcare expenditure will be needed globally per annum unless we can get the situation under control.

A lack of clean water and sanitation as well as inadequate infection prevention and control are some of the reasons why antibiotics are becoming ineffective. Then there is the food chain where the use of antibiotics in meat production as well as in our water supply is fuelling the rise of drug-resistant superbugs.

Good in moderation

The good news here is that new antibiotics are being discovered, which attack bacteria in different ways than existing drugs.

Ortino says that although the discovery of new antibiotics is positive, it is only part of the solution. "A plethora of actions need to take place," she adds. "One is having diagnostics to determine which specific treatment we should use. This would avoid using the wide spectrum of antibiotics, because the more you use them, the higher the frequency of resistance.

"It is important to remember that resistance of this nature is not a new phenomenon. This is bacteria's natural evolution in resisting the medication that has been found to kill them.

"The real problem is the speed at which the resistance is happening, which is down to the overuse of antibiotics.

"What we need to look at is the global consumption of antibiotics. The animal industry is where we believe that interventions predominantly need to take place," Ortino says.

We need to deal with antimicrobial resistance, otherwise we might not be around to deal with anything else.

Maria Ortino, Legal & General Investment Management

To halt the speed of drug resistance, investors' need to look at how animals are reared for the food chain, how pharmaceuticals, who supply the industry with antimicrobials such as antibiotics, undertake their antimicrobial resistance stewardship activities and how water utility companies are able to monitor and possibly treat the uncontrolled release and disposal of antimicrobial agents in the water system. "It's a combination of the misuse of [the antimicrobial], the overuse of it when it's not needed or the wrong use of it," Ortino says.

She likens the misunderstanding of how to fix the problem to asking renewable energy companies to up their game in the fight against climate change instead of engaging with oil and gas companies.

Animal welfare is important. Better feed would help keep animals healthier, hence not needing to be treated with antibiotics.

There are many instances where animals need antibiotics because they are not well cared for. Having too little space to move is one problem. "They get infections due to how they are kept, rather than the naturally occurring infections we all get," Ortino says.

"Action is needed today, rather than in five or 10 years. By then it will be too late," she adds.

Beyond medicine

Healthcare inequality is a systemic risk. "Capital should be directed to companies whose products or services enable a better quality of life or contribute to a more equitable world," Slaughter says.

This means that healthcare companies should be encouraged to look outside of their market to provide access to basic needs. These include efforts in sanitation, affordable housing, sustainable food, sustainable agriculture, education and financial services.

One company that has stepped in here is United Healthcare, which is building safer housing for the seniors it insures and provides access to healthier meals. "Providing a patient with safe housing and a better nutritional backdrop, hopefully makes them a better insurance risk," Slaughter says.

"In the US, such companies have branched out beyond pure healthcare provision to look at the social determinants of ill health, which largely drive illness if not rectified," he adds.

"We are seeing companies that historically have been siloed in medical devices, pharmaceuticals or provision of care, investing in projects to improve peoples' overall health.

"They are not doing this just from a societal perspective under the umbrella of ESG, but because it improves long-term wellness," Slaughter says.

Branching out

This approach to reducing the strain on healthcare systems and improving productivity should also be taken by the pharmaceutical industry. Could a drug designed to treat one condition be tested to see if it has a positive impact on other conditions?

One example is Abbott Laboratories. In 2012 it created Humira, a drug to tackle rheumatoid arthritis, a condition which has profound societal impacts in that it makes sufferers immobile. The drug changed how that disease effects society.

The good news does not stop there. Abbott has since discovered that Humira can treat nine other diseases, including psoriasis, ulcerative colitis and Crohn's disease.

"That is another trend," Slaughter says. "The ability to expand the playing field, to take a drug or technology and branch out to address unmet medical needs is likely to continue."

Fat loss drugs are another example of this serendipity. "Semaglutide is a fascinating drug developed initially for diabetes," Slaughter says. "Novo Nordisk [it's owner] ran separate trials and found that it is highly effective in lowering weight."

The drug's impact on obesity, which has huge health implications, is transformational. "How many knee surgeries do we do every year where if a patient dropped 30 pounds, we wouldn't have to replace that knee?" Slaughter says.

"There are six cancers we are aware of that are tied to obesity," he adds. "If we can cut the need to do those treatments for cancer 10 years down the road by treating obesity, we can knock down the need for orthopaedic procedures as a result of treating obesity."

How many knee surgeries do we do every year where if a patient dropped 30 pounds, we wouldn't have to replace that knee?

Steven Slaughter, Manulife Investment Management

A new era

These are examples of how the thinking is changing the healthcare industry and among those working to put food on our plate and supplying the water we drink. It needs to if we are to protect society from the many threats to our wellbeing.

If Covid highlighted anything, it is how quickly a virus can spread across the world. We have to realise that being on the other side of the globe is not a protection strategy.

"Diseases travel quickly," Ortino says. "If you misuse antibiotics or do not have access to them in places where there is an infection, that disease will travel quickly, and the resistance in that bacteria will travel with it.

"If there is a disease overseas, we can no longer see it as someone else's problem," she adds. "We need to take a global approach."

This is an attitude which appears to be long overdue. "The historical precedent has been that we are somewhat reactionary when these things occur," Slaughter says. "But for public health entities and governments – frankly, people with their hands on the cash registers – it would be more apt to think preventative as opposed to reactionary."

Times are changing. "We are at an interesting point in history where we are branching out and beginning to think beyond the current use of a drug or a device and how we can apply it to conditions that we do not have treatments for," Slaughter says.

Yes, this could be about boosting the revenues of developers, but if ailments are being treated there is a chance that it is saving the economy money in lost productivity and lower healthcare spend.

"Call me an optimist, but I have been in healthcare 37 years and the sky's the limit," Slaughter says. "There are a lot of things we can continue to work on that could improve humanity, improve our lives. Fortunately, they are coming from medical research labs."

Our health could turn into another crisis that governments and care systems lose control of in the coming years. But adopting a prevention strategy alongside testing new and existing drugs could help save the world from a threat that is up there with climate change.

Martin Lennon

Ed Clarke

SUSTAINABILITY: EXPANDING INFRASTRUCTURE'S PARAMETERS

While essentiality and high barriers to entry have long been trademark infrastructure traits, the asset class is increasingly being defined by sustainability. *Martin Lennon* and *Ed Clarke*, co-founders of Infracapital, share their insights on the accelerated drive towards sustainability, key trends and infrastructure's inflation protection qualities.

The first six months of 2022 saw the most active fundraising ever for infrastructure, surpassing $127bn (£102bn), according to data provider Preqin[1]. That slowed during the second half of the year as it became evident that the pace wasn't sustainable in terms of continued flows, but an impressive year for infrastructure, nonetheless. Looking ahead, Preqin expects infrastructure to achieve a compound annual growth rate [CAGR] of 13.3% by 2027[2].

What's been behind the rise of the asset class and where do we see the key opportunities today?

Martin Lennon: On the demand side, clients have increasingly recognised the benefits of the infrastructure asset class. At its heart, it's essential and resilient, which gives it the basis of which to be a strong performing asset class throughout the cycle.

Many investors see that as an important part of their diverse portfolio. Of course, it also has the ability to deliver yield and inflation, which has become a little more topical in recent months. Altogether we see a broad and growing opportunity set.

Some of the main themes that we have been following, which are still relevant today, are around decentralisation – moving infrastructure away from the centre closer to the communities from which it serves, technology or digitalisation, and increased focus on sustainability and everything that brings.

> **One of the core characteristics of the asset class is that it's a real asset class and therefore it does provide protection to inflation.**

Ed Clarke: It feels like the infrastructure space is going through a kind of industrial revolution at the moment. Historically, when we started, infrastructure was all about investing in existing, stable, secure assets like water companies and electricity networks. What we have seen in recent years is a drive towards sustainable sources of energy – accentuated by the war in Ukraine – and the need to have resilient local infrastructure, which has driven a change in the way infrastructure is provided.

You layer on top of that the technological changes, and it gives rise to a whole new set of opportunities, and we have been working hard to play in that space.

If those are the trends, what specifically have you been looking at?

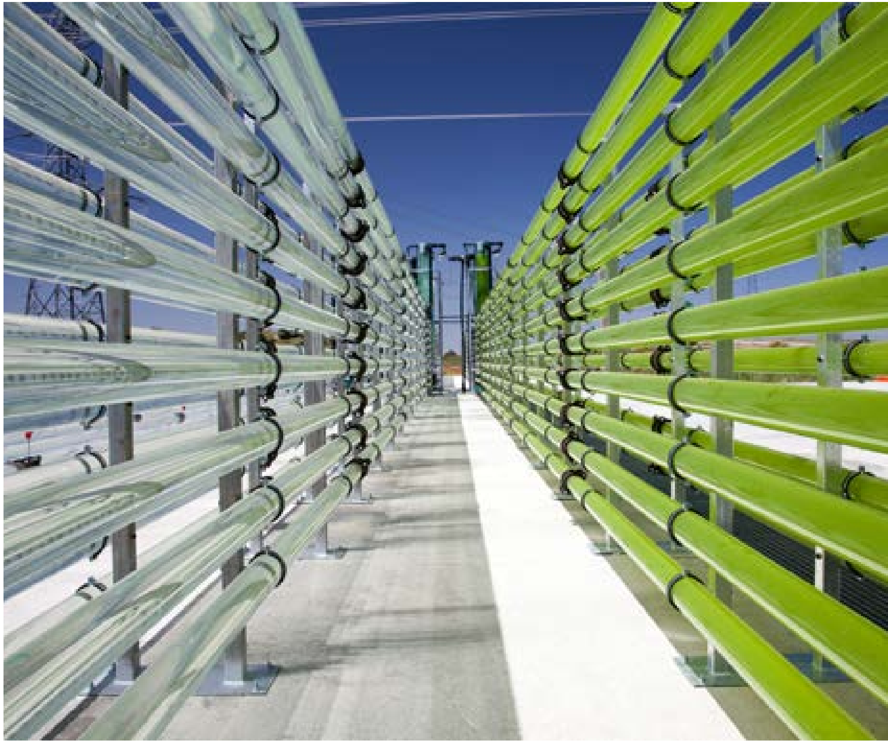
Clarke: We have had a number of key themes which drive it. For me, one of the most interesting ones at the moment is looking at the way big corporates are all setting net-zero targets, and then trying to backfill their supply chains and processes to deliver on that net-zero promise. A great example in our portfolio at the moment is a business in the Benelux called Inland Terminals Group. It operates terminals inside the factories and distribution centres of major European corporates who receive goods from Asia via the ports of Antwerp and Rotterdam.

What our business does is move these goods by barge to their distribution centres or to their factories, taking trucks off the road and allowing them to significantly cut their carbon emissions. On top of that, we are now working with some of those customers. Nike is an example where we are introducing hydrogen power barges to make that leg of the supply chain carbon negative.

How do you see our role when it comes to plugging infrastructure gaps in order to deliver positive and measurable outcomes for our communities?

Clarke: We have a crucial role in delivering the capital that's needed to enable a lot of these projects and businesses to prosper. As the world goes through this kind of industrial revolution, we see in some of the major corporates that used to be the traditional bellwethers of the infrastructure space – the big utility groups, the big telecoms groups – that they often have small business units trying to develop and do things, but they find it difficult to access capital because it's not part of the core business.

1) Preqin, "Preqin quarterly update: Infrastructure Q4 2022", preqin.com, January 2023.
2) Preqin Global Reports 2023: Infrastructure.



A great example – we entered into a partnership with Fortum, a big Nordic utility, where we took a 70% stake in its electric vehicle charging business across the Nordic region. This business – probably the leading one in the region – had developed so far, but actually, the need to keep developing it required a lot of capital, which Fortum wanted to share the burden of.

We came in initially with a 70% stake and we have now taken 100% control of that business and are reinvigorating the management and accelerating that growth, which is obviously a key part of the transition to electric vehicles in that region.

I see our role as working with businesses, working with entrepreneurs, working with the major corporates to help the visions that they have about the development of infrastructure become a reality.

Infrastructure is traditionally associated with a degree of inflation protection. What is the relationship between the two and how does the asset class offer protective benefits when it comes to inflation? As investors, what else can we do to de-risk and make our assets resilient?

Lennon: One of the core characteristics of the asset class is that it's a real asset class and therefore it provides protection to inflation. We have all been a bit spoiled because inflation's been low and it's been stable for such a long time that we have lost sight of it. Of course, the past 12 to 18 months have put that back into prominence.

Actually, it has been a great learning experience for people that are not that familiar with infrastructure and the inflation protection qualities that the asset class brings. Let's remind ourselves why infrastructure provides inflation protection, and it comes in a variety of different forms.

Regulated industries, such as utilities, often have a regulated pricing model, which is reviewed periodically by the regulator of that particular sector. That normally provides for quite a significant degree of inflation passed through, so it's baked into that regulatory model.

Equally, infrastructure businesses that operate through long-term contracts, again, often have inflation protection mechanisms embedded within those contracts, so another form of inflation protection. Even those infrastructure businesses that do not have these two qualities, if they have a strong market position, going back to that essential characteristic, then they are well placed to be able to pass on inflation to their customers, be they businesses or otherwise.

Whilst I wouldn't say inflation is 100% perfectly hedged within the infrastructure space, if you look across different asset classes, infrastructure stands out as being one of the best in times of high inflation.

We still need to be mindful of the broader stakeholders. Spikes in inflation can have significant impacts on businesses and customers as we know, so we cannot be complacent.

We still need, as infrastructure business owners and managers, to make sure that we do everything we can ourselves to mitigate the impact of inflation rather than just relying on passing it through to the end customer. That way we continue to maintain our license to operate, if I can put it in that way, given the importance of the sectors that we invest in.

Clarke: The watchword when we are looking for new investments is that essentiality is the key component and that is what justifies the infrastructure tag. Essentiality, high barriers to entry and sustainability more and more at the moment.

Those characteristics and the customers' need for the service that you are providing, no matter the economic environment, gives you security and safety, which is why investors have invested so heavily in the infrastructure asset class of late.

M&G Investments

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DIVERSITY HUB

Diversity takes many forms. However, bringing people from different socio-economic backgrounds to the table could provide the alternative thinking that decision-makers need. For this month's Diversity Hub, we spoke to Aon's Jennifer O'Neill to discuss the importance of diversity of thought.

Members

FEMALE TALENT STRUGGLING TO REACH THE TOP OF THE FINANCIAL SERVICES INDUSTRY

Pension funds have more women in leadership roles, but the wider financial services industry needs a push, finds *Andrew Holt*.

At the current rate of progress, it will take 140 years to achieve parity between men and women in leadership positions in the financial services industry, based on the latest Gender Balance Index.

The index, now in its tenth edition, tracks the presence of who is holding senior positions in central banks, commercial banks, pension funds and sovereign wealth funds.

Across the sample of 336 institutions, 14% are led by women. This is slightly up from 13.7% in 2022 and 13.3% a year earlier. Representing a marginal increase in each of the last three years.

However, female representation is better lower down the ladder. Women make up around a quarter (24%) of deputy governors and c-suite staff, and almost a third (30%) of the 6,221 senior staff across all institutions in the index.

The Official Monetary and Financial Institutions Forum, which compiles the data, digs deeper to consider the types of senior roles women are holding.

It finds that 62% of female executives in commercial banks, pension funds and sovereign wealth funds are in revenue-generating roles. That compares to 83% of their male peers.

What's the score?

The index encompasses these key data points into a single metric of gender balance for individual institutions. It takes the share of women and men in senior management or board positions, with greater value given to higher ranks such as governor or chief executive.

A score of 100 means an organisation has achieved a 50-50 gender balance. The 2023 index scores reinforce the overall message of slow progress. All institutions advanced their index scores in the past year by 1 to 2 points.

Pension funds stand out in this scenario. They continue to outperform with an aggregate index score of 50 out of 100 – meaning they are just halfway to achieving gender parity.

In comparison, the global score for commercial banks and central banks is less than 40, and is only 23 for sovereign funds.

Here the index pointed out that there is only one additional female governor of a central bank globally compared to 10 years ago.

Samantha Gould, head of campaigns at Now Pensions, said the report is another chance to raise awareness and draw attention to the issue of gender parity at financial institutions, but also shows how quickly awareness must be followed by action.

"Redressing the gender imbalance is a complex issue," she said. "But progress continues to be slow when you think that anyone born in the year of the UK's Equal Pay Act [1970] would almost be old enough to start accessing their pension savings."

Highly symbolic

Seeing only nine female chief executives in the FTSE100 is, Gould said: "Symbolic of the many issues which need consigning to the past, including the gender pension gap and the barriers that prevent many women from accessing funding to start their own businesses.

"Locking experienced women out of senior roles is not in the best interest of society or individual businesses," she added.

Barbara Rambousek, director of gender and economic inclusion at the European Bank for Reconstruction and Development, noted how the index reveals how much work is needed on gender representation. "There is a lot to be done to make the financial sector more gender equal and inclusive – and a call to action for us all," she said.

To assist in this, the CFA Society UK has opened applications for the second year of its Young Women in Investment programme, to accelerate the change needed in the investment industry and to combat the gender gap.

The programme consists of a four-week virtual 'bootcamp' and is open to female students graduating within the past two years.

Industry understanding

They will have access to a mix of instructor-led sessions and self-study learning materials with the aim of building investment industry knowledge and business skills for the workplace.

Participants will be introduced to investment management concepts, including an overview of the industry, regulations and regulators as well as macro and micro-economic factors.

Alongside a broad understanding of the industry, candidates will also learn about risk management, portfolio construction, different asset classes and capital markets.

Sarah Maynard, global senior head of diversity, equity, and inclusion at the CFA Institute, said gender diversity remains a challenge in the investment industry – a point highlighted by the Gender Balance Index. "While many UK firms have adopted a 50/50 approach to entry-level recruitment, more work is needed to create opportunities for women to enter the industry through non-traditional routes and in ways that shore up their chances for ongoing success," she said. "That's why we are delighted to announce the return of our Young Women in Investment programme in the UK."

Last year, the CFA piloted a UK programme with 40 'bootcamp' participants and eight investment firms offering internships. "This year we hope to build on that success by offering bright, hardworking and self-motivated individuals a route into the investment industry," Maynard added.

INTERVIEW – JENNIFER O'NEILL

Diversity: A different view

Andrew Holt talks to Jennifer O'Neill, associate partner at Aon, about the appeal of alternative thinking and how social mobility is vital in addressing diversity within the investment industry.

What themes are key in the diversity debate within institutional investment?

There are three lenses I tend to consider when thinking about diversity in institutional investment. One of those perspectives is: is there enough diversity of ideas? By which I mean, when selecting investments, are the right ideas being suggested, critiqued, discussed and ultimately selected?

That's the first perspective. But in order to do that, you need to have diversity of thought. You need to ensure that there is a fairly open, collaborative and inclusive environment where such ideas can be brought forward to be critiqued properly and the appropriate decisions be taken.

Diversity of thought brings us into how you might think about building a team, which is my third lens. When building a team, we need to consider a number of factors. We can have a team of people who share a similar background in the way they think, so are not necessarily diverse in the way they generate ideas. So that diversity of thought perspective applies internally [as an organisation] and also externally [as an industry].

So when selecting investment managers, who run capital on behalf of pension funds day-to-day, consider if they are diverse in the way that they think, critiquing ideas and ultimately factoring those into the portfolio construction process?

Of those themes, which is the most important?

I see them as interlinked. It is difficult to suggest that one is more or less important than another because they all contribute towards strengthening the decision-making process and that permeates through each investment decision investors make. The critical point around the diversity of thought piece is how can it be understood, conceptualised and ultimately factored into decision making.

What ideas are being generated from that diversity of thought process?

It is more from a principle perspective. During the past 12 to 24 months, it has been a pretty challenging market environment. There has been lots of volatility and lots of shifts in the way that the market is evolving. It is, therefore, important to consider alternative ideas to those you have perhaps chosen during what has been a more benign period in the past decade or so.

We are in a changing state of flux. We need to make sure that there are ideas being brought in which are adaptable to the current state of affairs. Diversified alternatives are, for example, one perspective that may be relevant. But in order to do that you need to have a well-equipped

I'm working in the investment industry, but it wasn't always inclusive in the way that I perceive it to be now.

team to be able to assess that and understand the opportunity set.

Is the industry embracing these ideas, or do we still have a long way to go?

This is evolutionary. I have seen a lot more focus on diversity within the investment industry. It probably comes as no surprise that the investment industry in terms of people composition tends to be fairly standardized. There is less representation of people from a lower socio-economic background, for example.

But there are necessary points to look inwards, to understand why that's the case and understand what can be done to change that. The industry is willing to do that, but it will take time.

We are at an evolutionary point that will take some time to play through.

Do you think the socio-economic and mobility narrative has been put on the back burner in favour of other narratives, such as a focus on gender and race?

It is a good question. More easily observable characteristics, such as gender and race, can be easier to focus on. One could argue that something like socio-economic mobility is more difficult to measure.

Is the launch of the City of London Corporation-led Socio-Economic Taskforce to address this issue a step forward?

All initiatives in this space are a step forward. It is important that we recognise that there are desirable evolutions, they are relative to the current position and look to change those.

A focus on these issues is a positive step, but, as I have said, it will take some time.

Is another issue one in which these initiatives exist in something of a vacuum, undertaken by particular individual organisations, but do not exist holistically as an industry. Therefore, is there an impetus to change them across the board?

It's an interesting point. What I would point to though is there are a number of quite large industry collaborations on this. The Diversity Project is a widespread initiative, for example. This type of collaboration illustrates what I talked about earlier in terms of that genuine willingness from the industry to make progress in this area.

How should the industry deal with the social mobility narrative and switch the dial forward to get something done?

Some real positives I see are at the early career stage. When organisations are looking to bring in new talent and look at the junior level to do that, then one area where we have seen some development is no longer exclusively focusing on graduate recruitment.

Here the thinking has been about apprenticeship recruitment or opening up recruitment opportunities to those who may not have gone down a traditional educational path. That is positive.

Secondly, even when looking at graduate recruitment, doing that on a basis which is deviating a little from the traditional or historical perspective of only looking at red brick universities or Oxbridge, are the focal points in terms of bringing in that talent.

One of the things we have done, and done for a number of years now, is redacting the university information from graduate CVs when they come in. We are trying to minimise bias in terms of the recruitment process.

So there are some quite easy and meaningful steps organisations can take in order to broaden the potential pool of talent and consider the way they are assessing that talent and bringing that into the organisation.

That means the industry has to take a step back and look at who they are recruiting instead of just promoting people within the organisation from a particular background. They have to step back and get involved in education and universities.

That's right. You mentioned promotion. That is crucial in terms of internal promotion processes that also need to be considered here.

Again, that's something Aon has done a lot of work on. I'm sure other organisations have done so similarly in order to think about the degree to which those processes are inclusive: that they are open and accessible. So that such people who may not be at the point of being ready for promotion or those who feel that they are ready for promotion, see a clear roadmap as to how they could progress to that next stage in their careers. Internal promotion processes are important to think about, as well as that more outward looking external recruitment point.

The critical point around the diversity of thought piece is how can it be understood, conceptualised and ultimately factored into decision making.

How can we turn these initiatives and ideas into standardised objectives? Who needs to get involved to bring all this together?

Joined up thinking is absolutely key. To that end, what I would point to is individual organisations undertaking their own initiatives relative to cross-industry collaboration. This is an area where cross-industry collaboration is powerful.

I would look to initiatives such as the Diversity Project in order to benefit from cross-pollination of thinking and developing internally by using those.

Is the institutional investment industry going in the right direction on diversity?

I do see there being some real positives here. From a personal perspective, I'm married to a woman. I'm gay. I feel more than ever before absolutely accepted and included within the industry that I work in. I feel happy about the position I'm in. But I also have to say that wasn't always the case. I'm working in the investment industry, but it wasn't always inclusive in the way that I perceive it to be now.

I do feel that there are some real positive developments here and I hope that others feel similarly.

What would you suggest as the key takeaways from this?

The key takeaway is to think about: are you considering how you are making decisions. Really consider the teams that you are part of. And if you feel that you have a diverse representation of thought around the table, think also about the way that you measure and consider diversity.

We have talked a little bit about observable characteristics relative to those, which are less easily observable. So consider the extent to which that may be the case and look to those external collaborative initiatives that I talked about in order to benefit from the huge wealth of thought leadership and ideas that are coming through.

DIVERSE INVESTMENT MANAGEMENT: SQUARING THE CIRCLE

The aim of achieving greater investment outcomes with diverse managers is a much-discussed issue. In fact, some would say it is more talked about than acted upon.

One investment firm that has been looking at this issue for some time is Cambridge Associates, which revealed it has already met its five-year goal set in 2020 to double its investments with diverse managers from 5% to 10%.

Jasmine Richards, head of diverse manager research at Cambridge Associates, is making sure the company is not resting on its laurels. "The work is never complete," she says. "But when investment decisions can be grounded in more equitable processes, they can ultimately drive toward the most positive outcomes for everyone."

Sticking to this principle, Cambridge has now set a 15% diverse manager target for 2025.

There were a number of driving forces that propelled Cambridge Associates to meet its diverse manager goal.

Notably, and most revealing, was the commitment of the firm's diverse manager research team who worked to integrate diversity measures throughout the due diligence process and show a commitment to sourcing and evaluating a larger funnel of opportunities.

Cambridge revealed that it wasn't until this intersected with an increase in client demand for, and willingness to invest in, diverse managers that meaningful momentum took shape.

Cambridge reveals that 62% of its clients hold investments with diverse managers, an impressively high number.

Furthermore, a survey of clients across the US, Europe and Asia identified social equity – including gender and race – as a top driver for investing to make an impact.

Evidence that asset owners are influencing the debate in ways that could well reshape the investment universe in terms of diversity.

This is especially important given that the approach to diverse manager investment has, as highlighted, been more discussed than embraced and been somewhat *ad hoc* as a result.

Melinda Wright, global head of diversity, equity and inclusion at Cambridge Associates, highlights how the idea of diversity should underpin a commitment to diverse investment for it to work.

"We believe that inclusive teams make better decisions, demonstrate greater collaboration, bring forth bolder ideas, and drive better financial and investment outcomes," Wright says.

To support these beliefs, she says Cambridge Associates has committed itself to take on two roles in the diversity debate: acting as stewards of long-term capital and also as champions of change and opportunity.

LGPS POOLING: WINDS OF CHANGE

Could the dramatic changes to pooling announced in the Spring Budget trigger more collaboration or competition between pools? *Mona Dohle* reports.

In the eight years since then chancellor George Osborne announced his ambition to pool the assets of local government pension schemes (LGPS), the UK has had no less than seven chancellors. While they all belonged to the same party, their policy visions have at times been vastly different. One aspect that united them is a shared ambition that the LGPS pools could become something akin to a sovereign wealth fund for the UK. A greater concentration of assets would offer a convenient plug for the UK's infrastructure funding gap and a source of funding for the private sector at a time when the government needs to tighten its purse strings.

That, of course, is not how the LGPS pools see themselves. Having said that, pooling has accelerated rapidly, with eight such entities firmly established, and managing most of their member funds' assets.

Enter Jeremy Hunt's spring Budget in March, which perhaps marked the biggest political turning point since the launch of pooling in 2015. The relatively new chancellor made it clear that he would like to increase not only the pace, but also the speed of pooling, with all listed assets to be transferred to a pool by March 2025.

The government also wants to see a smaller number of pools with assets of at least £50bn. While the consultation is ongoing, this announcement could trigger significant changes to the pooling process, but there could be pitfalls along the way.

Same but different

When the government first launched the proposal to pool assets, it combined an ambitious timeline with deliberately ambivalent targets. Within a few months, authorities were asked to submit their proposals for pooling, with each "sovereign wealth fund" managing at least £25bn in assets. At the same time, the definition of what constitutes a pool was left open, allowing for the emergence of different setups.

On the one hand, pools like Local Pensions Partnership (LPP), which have relatively fewer partner funds, took responsibility for managing their funds' assets from the beginning, becoming their custodians. Border to Coast was established as a regulated manager in 2018 with the partner funds acting as shareholders. LGPS Central pursue a similar model.

All three pools are FCA-regulated and Mifid II-compliant with an Authorised Contractual Scheme (ACS) structure and offering an in-house investment management capacity. Crucially, while the pools provide support on asset allocation, the decisions are ultimately taken by the partner funds.

Then there are Access and Wales Pension Partnership, which are also Mifid-compliant and operate a rented ACS structure, where the investment management is outsourced. Brunel Pension Partnership, which is also FCA-authorised and Mifid-compliant, has outsourced its custody and fund administration. It uses a combination of internal and external management.

London CIV also has an ACS structure but has struggled to convince all its partner funds to transfer their assets. Unlike other pools, it has 32 partner funds whose interests need to be united. A daunting task.

Meanwhile, Northern LGPS started pooling its illiquid assets whilst keeping the management of the liquid, listed exposures with the individual partner funds. These include West Yorkshire, which has long-standing in-house capacities while Greater Manchester has active mandates with external managers.

It appointed an external FCA-authorised custodian two years ago to ensure all its listed assets are within a single authorised entity. But the asset allocation decisions remain within the individual partner funds.

In a nutshell, the eight funds have opted for different approaches to pooling, a fact which could become a challenge, should the government wish to see them join forces. .

Deadline pressure

Despite the absence of a clear definition of what constitutes pooling, the government now paces ahead with the demand that all listed assets should be pooled within the next two years. At first glance, it seems as if the pools should meet this target with flying colours.

Border to Coast and Brunel have transitioned more than 80% of their clients' funds, putting them on course to meet the government's target. Similarly, Access says it has pooled £32.7bn, which accounts for more than 80% of its partner funds' combined £57bn of assets. Meanwhile, in March 2022, London CIV managed 57% of its client funds, while just over half of the assets belonging to LGPS Central's member funds have been pooled.

It remains to be seen how the government's consultation will assess Northern LGPS' approach, but the pool is confident that it complies with the rules, given that it is not a separate legal entity but uses a joint committee structure and has a joint custodian. LPP also describes itself as 100% pooled, given that partner funds handed responsibility for all of their assets to the pool at inception.

But the picture changes somewhat if pooling's progress is being assessed from a bottom-up, rather than a top-down perspective. When considering the progress of individual partner funds to pool their assets, it appears that some funds have failed to commit any of their assets to their pool and remain reluctant to do so.

This was brought to the public's attention when some of London CIV's partner funds – the Borough of Bromley and Kensington and Chelsea – announced they were considering leaving their pool. It also emerged that Bromley is yet to pool any of its assets.

For William Bourne, a principal with Linchpin, a consultancy, the root of the problem remains the lack of a clear definition. "We desperately need some more direction from the Department of Levelling Up, Housing and Communities because there is a great deal of uncertainty in a whole range of areas, whether it is governance or pooling," he says.

Chris Rule, LPP's chief executive, seconds this view, arguing that the government's lack of long-term vision is a key reason for reluctance among some funds. "The government has been imprecise and not set out a clear directive and that has resulted in inertia. There are still a lot of conflicting views, there is mixed appetite, too many decision makers, such as consultants and asset managers, and it's not necessarily in their interest to see further pooling. There are all sorts of agents out there that can muddy the waters.

"What the government can do is be a bit clearer and provide requirements to be a bit more transparent, for example about costs and performance so that you can compare apples with apples and see what was successful and what hasn't been," he adds.

Is bigger always better?

For some in the industry, the government's sudden rush to increase the pace of pooling is in large part motivated by an interest to attract LGPS cash. "If you go back in history, the government has always had a different idea of what pooling means to what the LGPS has," Bourne says.

"The government has always seen it as a vehicle to finance their projects, which is 100% not what it should be about. These are pension funds; they are there to pay pensions to their members who ultimately own that money. So there is quite a bit of conflict between these two.

"Where the government is right is to look at achieving cost savings," he adds.

But this raises the question whether bigger funds always deliver better outcomes, a premise which Bourne questions. "One of the reasons why they pushed for pooling is to push for scale but I am not convinced that you need bigger scale to get lower costs.

"I can see that it ought to be helpful because you can spread fixed costs over a higher number of assets but the Wales pool, for example, has done this by outsourcing to a private sector consultant and that is an equally efficient way of doing it," he says.

While Chris Rule agrees that bigger funds offer economies of scale, he also predicts that solely focussing on the size of a fund could offer pitfalls. "For me, bigger won't be better if it is fragmented. If you end up having a bigger pool of assets that isn't

One of the reasons why they pushed for pooling is to push for scale but I am not convinced that you need bigger scale to get lower costs.

William Bourne, Linchpin

No one is going to invest in anything because the government thinks it's a good idea, they are going to invest if they think it's a good investment.

Chris Rule, Local Pensions Partnership

actually pooled you can talk about a big number but that isn't effective scale," he says.

Richard Harbord, a consultant to LGPS funds, is sceptical of the government's aim to reduce the number of pools. "It seems to me that cutting down the number of pools could cause chaos because the partner funds would have to move and some have only just put their investments into the pooling system. So that could cause huge upheaval and I am not quite sure of the benefits," he says.

Collaboration or competition?

The government's focus on scale has the potential to change the tone of the debate around pooling. One factor that makes LGPS unique in the financial services industry is a strong element of collaboration.

Pools have been working together closely on infrastructure investments. GLIL, which joins up pools and even a defined contribution provider, is a case in point. It was established to provide more efficient infrastructure investments. Another example is collaboration on shareholder engagement, with various pools joining together to increase their voice as shareholders.

But with all partner funds having committed to a pool, could the government's focus on the size of pools introduce a process of increased competition between pools to attract partner funds from other pools in order to increase their size?

For Bourne, this scenario is on the cards, and that might not be a bad thing. "There are two different visions here and you'll find passionate defenders on both sides," he says.

Bourne warns that if a fund's committee members are effectively being forced to remain in a pool which they believe offers poor investment outcomes, this could conflict with their fiduciary duty to act in the best interest of their members. Instead, they should be free to move between pools.

"My view is that the government should let funds move either assets or even to different pools," he says. "This keeps everybody honest. You get a process of Darwinism whereby the better pools will attract money from other funds."

A question of accountability

The Royal Borough of Kensington and Chelsea and the Borough of Bromley ultimately decided to stay with London CIV, a decision which may have been influenced by regulatory pressure.

While the government has no jurisdiction over the pools, it does have jurisdiction over the funds and in an extreme case, the secretary of state could intervene and remove the administering authority.

But this raises a whole number of governance questions, which go far beyond London CIV. Who assesses whether a pool underperforms? And should funds be allowed to leave if they are dissatisfied?

For Harbord, this could be a potential source of conflict. "I have always thought that the trouble would come when some local authority would put its money into a pool and doesn't feel like it's going to get enough return. So what do they do about it? They can take their money out and put it into another fund but they can't put it into another pool so they are stuck.

"Eventually, there are going to be cracks appearing on this and there is not any regulation to deal with that, so it is an imperfect system," he says.

Bourne also sees governance issues as the more important challenge to be resolved. He argues that the need for better governance standards has two elements. On the one hand, there are the funds which should be holding the pools to account and on the other, there are the pool boards holding their management to account.

"My killer question is: could any LGPS pool do what Alecta [the Swedish pension fund] did and fire their chief executive? I don't think any of the pools could do that," Bourne says.

While the government's consultation is pending, the mood among LGPS suggests the government might receive different responses than they might have anticipated, Rule says. "The government wants the investment, but I am not sure that bigger gets them there.

"It's about making sure you have the right investment governance. No one is going to invest in anything because the government thinks it's a good idea, they are going to invest if they think it's a good investment," he adds.

THE FINAL COUNTDOWN

69%

...of professional investors intend to maintain or increase their exposure to commodity ETFs this year.

Source: Brown Brothers Harriman & Co

87%

...of local government pension scheme property funds will increase their focus on making a positive social impact in the next 12 months.

Source: Alpha Real Capital

72%

The level of asset allocators globally who intend to increase their exposure to private markets in 2023.

Source: Blackrock

52%

The professional investors planning to add ESG to their ETF holdings in the next 12 months.

Source: Brown Brothers Harriman & Co

$42.6bn

The net new assets raised by European ETFs during the first quarter, up from $27.2bn in the previous three months.

Source: Invesco

82%

Income generation has been named by 82% of asset allocators globally as the main driver for investing in alternative assets.

Source: Blackrock

34%

The percentage of family offices intending to increase their allocation to real estate by more than 50%, while a third intend the same rise in their private debt exposures.

Source: Ocorian

23%

Almost a quarter of UK investors intend to invest in gold this year to protect against volatility.

Source: The Royal Mint

€2.5trn

The expected value of assets managed by ETFs in Europe at the end of 2030, almost double the €1.2trn recorded in December.

Source: Refinitiv Lipper

Quote of the Month

"Central banks have approached this current inflation environment as if flares and long hair were all the rage."

Neil Mason, Surrey Pension Fund

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