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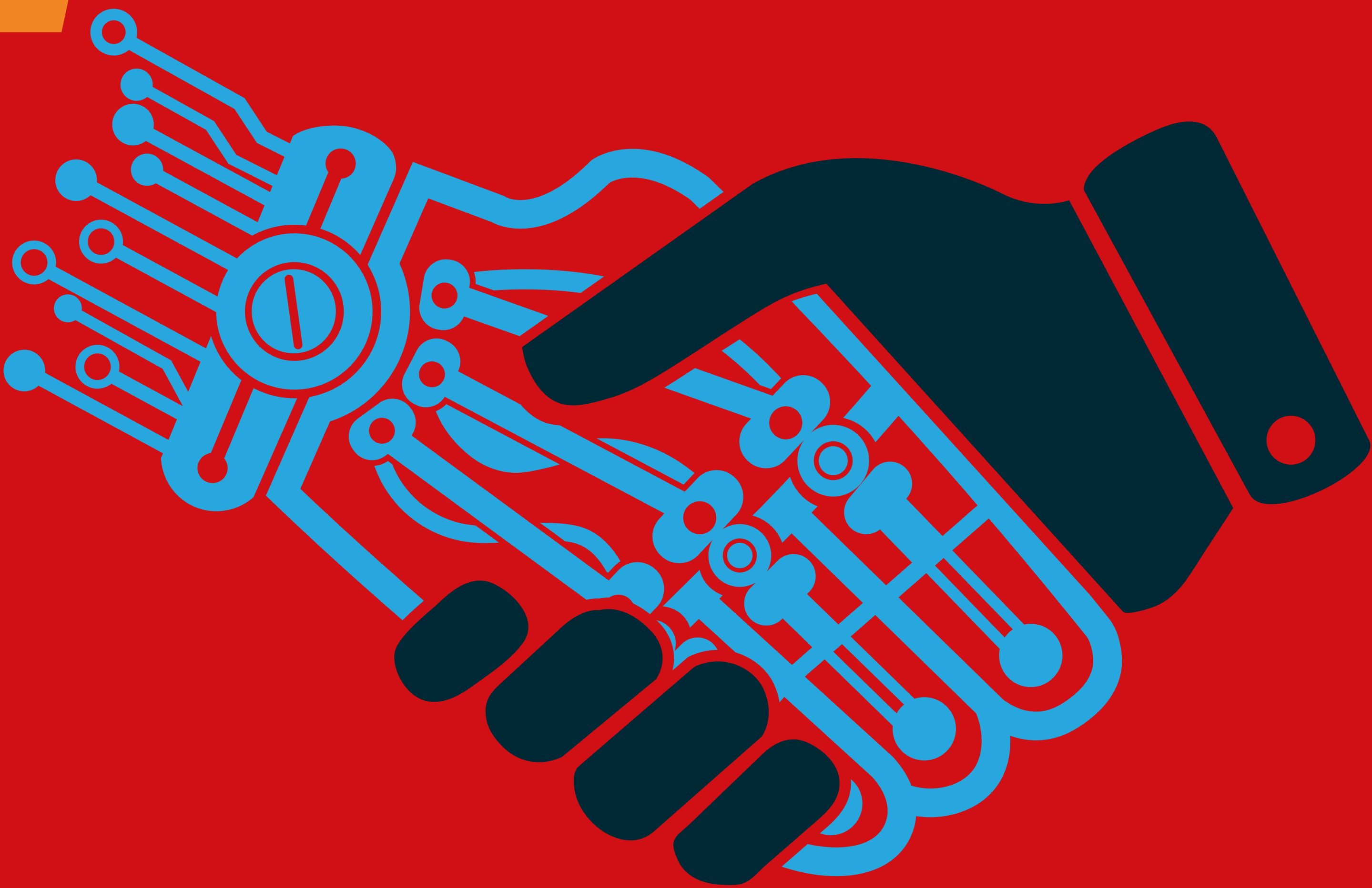
AI: INTELLIGENT INVESTING?



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AI: INTELLIGENT INVESTING?

It has been hailed as the saviour of humanity by some, while others fear it could lead to our extinction.

Artificial intelligence (AI) could make breakthroughs in medical research that saves lives, but there is a risk that it could become oppressive if given free will.

For the pessimists, who include the late Dr Stephen Hawking, popular culture is littered with examples of the dangers that AI could pose.

In 1984's *The Terminator*, AI was put in charge of the US defence system and decided to start a nuclear war, while in *2001: A Space Odyssey*, the ship's computer decided it was in its best interest to kill the crew by switching off their life support systems.

These are, of course, fictional and there are those who are more optimistic about the technology. They believe that AI will make us more efficient, productive and speed up decision making.

But there are real fears that it could replace the need for people to work in industries such as IT, banking, marketing, manufacturing and journalism (please note: a machine cannot do a better job than wot I does). Indeed, two-thirds of jobs in the US and Europe are believed to be under threat from greater automation.

The question is: if AI could develop new antibiotics, write songs and set a legal defence in court, could it also make us better investors?

Our cover story this month looks at what benefits AI could have for those managing assets and how they should use it? Find out from page 16.

This edition also looks at what the changing geopolitical scene means for institutional investors (*p.22*), if we are winning the battle to create efficient sources of clean energy (*p.38*), how private equity could perform in a new investment environment (*p.46*) and how to make collective defined contribution (CDC) schemes more appealing (*p.50*).

We also speak with Jane Firth, who discusses how Border to Coast is driving real change (*p.34*), while the TfL Pension Fund's head of investment reminds us that not every scheme suffered during the LDI crisis (*p.12*).

We hope you enjoy the issue.

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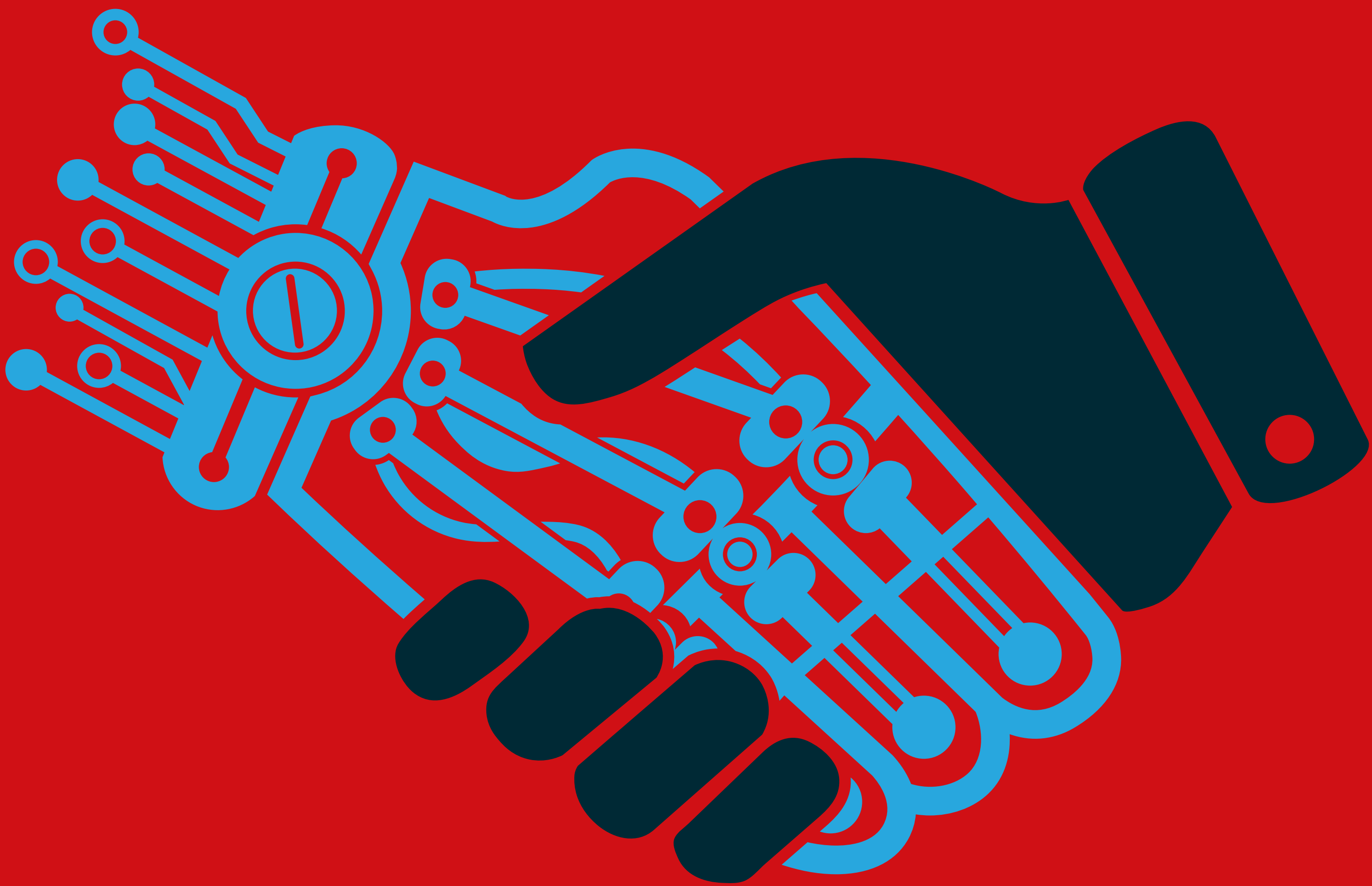


INVESTORS, SHARE BUYBACKS AND THE 'MANIPULATION' OF SHARE PRICES

The constant growth of share buybacks raises issues for investors, as well as questions about how long the trend can continue. *Andrew Holt* investigates.

The march of share buybacks continues unabated as they grew last year by 22% to a record $1.3trn (£1trn), exceeding the previous record set in 2021, according to Janus Henderson.

This though is a trend that goes back further than the past two years. Buybacks worldwide have almost tripled in value in the past decade – highlighting the depth of its growth.

Indeed, every region, almost every country and almost every sector have seen buybacks grow strongly.

The biggest jump came in 2018: mainly caused by US technology companies ramping up their buyback programmes. The consequence of this rapid growth is a significant increase in the importance of share buybacks.

In 2012, globally they were equal to just 52% of dividends, ranging from 3% in emerging markets to 102% in North America.

Yet in 2022 the global figure jumped to 94%, ranging from 18% in emerging markets to 158% in North America.

By far the biggest contributor to growth in 2022 came from the oil sector, in which companies bought back $135bn (£108.6bn) of their own shares, more than four times as much as 2021.

Almost all the oil-sector cash was spent by companies in North America, the UK and, to a lesser extent, Europe.

Big tech, big buybacks

Some sector variations are even starker. In the media sector, for example, which includes Facebook owner Meta and Google's parent company Alphabet, neither company pays a dividend, but both are big buyers of their own shares.

The global value of the sector's share buybacks was eight times larger than the dividends paid in 2022.

By contrast, in the high dividend-yielding utilities sector, dividends were eight times larger than buybacks. Adding buybacks and dividends together, the so-called total shareholder yield, significantly reduces the differences.

As with most market trends, the figures are concentrated in a few companies, always the market behemoths. Apple is one of the world's largest buyers of its own shares, worth an astonishing $89bn (£71.6bn) in its 2022 financial year, almost 7% of the global total.

The 10 largest buyers accounted for almost a quarter of the global total and only one of these, Shell from the UK, was outside the US. Nestle was one of Europe's largest buyers of its own shares last year.

Shareholder value?

This has led to some investors raising concerns that the practice is boosting senior executive payouts while providing little benefit to shareholders.

Euan Munro, chief executive of Newton Investment Management, has been one dissenting voice. He said that he would prefer share buybacks to be "less prevalent".

Munro notes that share buybacks can be used to "manipulate [earnings per share] numbers upwards" to meet medium-term management incentive targets at the expense of investments that might be important to a company's long-term health.

Of course, this in itself reveals an important motivation of share buybacks: the short-termism of market expectations.

In essence, the rise and rise of share buybacks has resulted in massive amounts of company cash being used not to reinvest in the business, or pay conventional dividends, but to buy shares for cancellation.

Vartika Gupta, a solution manager at McKinsey, said buybacks offer no value for investors. "Share repurchases are a good way to return cash to those who can invest it better than a company at the limits of investment capacity, for whatever reason. But buybacks don't fundamentally create value," she said.

A point shared by Ben Lofthouse, head of global equity income at Janus Henderson. "Buybacks cannot always be relied on to enhance shareholder returns."

And he added that the rapid growth in buybacks in the past three years reflects "a willingness to reward shareholders without setting unintended expectations for dividends".

Getting to zero

Simon Rawson, ShareAction's deputy chief executive, highlighted another issue connected to the rise of share buybacks, one seldom mentioned: the connection to net-zero commitments.

"As the International Energy Agency has highlighted, the amount returned to shareholders [by fossil fuel companies] in the form of dividends and buybacks could have been reinvested to meet our net-zero investment requirements in all clean fuels until 2030," he said.

Although many investors would see this as problematic, as Rawson is equating buybacks with dividends. And the whole point is that they are not the same – given that buybacks give returns to select shareholders, which breaks the central principle of being an investor.

Where does the seemingly never-ending trend of greater buybacks go from here? One strong reason exists for suggesting the future consists of a buyback slowdown. This is based on the simple fact that the global cost of capital is now significantly higher, suggesting the buyback rise of recent years is not sustainable.

CALPERS TARGETS PRIVATE EQUITY INCREASE

The US pension plan looks to private companies to boost its returns and long-term funding position, finds *Andrew Holt*.

The US' largest public pension plan – the $456bn (£368bn) California Public Employees' Retirement System (CalPERS) – is to increase its allocation to private equity.

The move comes after former Border to Coast chief investment officer Daniel Booth was recruited as deputy chief investment officer for private markets in April.

CalPERS, which is already one of the world's biggest private equity investors, has confirmed that it is undertaking an extensive review of its holdings with the intention of expanding its $52bn (£42bn) private equity portfolio.

Chief executive Marcie Frost said from an investor's viewpoint there is an appetite to put "more money into private equity".

It comes on the back of an announcement in January, when CalPERS said it was increasing its allocation to private equity to 13% from 8%, which began with the 2022-23 fiscal year.

CalPERS also made a $1bn (£808m) commitment to identify and support the next generation of investor entrepreneurs in the private markets sector.

"CalPERS is committed to giving access and opportunity to new and innovative talent in the investment industry," CalPERS chief investment officer Nicole Musicco said. "We want to create and nurture an ecosystem that will serve as a catalyst to seed the next generation of diverse talent and foster different ways of seeing and solving problems."

Inflation protection

Private equity is key to the scheme's prosperity. "Efficient implementation of private assets will be key to achieving the returns needed to grow the fund and improve our long-term funding position," Booth said.

He added that private markets continue to provide inflation protection and diversification, as well as the excess returns CalPERS needs to meet its pension obligations.

Private equity is the highest performing asset class in the CalPERS portfolio returning 13% during the past five years and 12.8% over a decade. Overall, the CalPERS portfolio earned 3.3% for the year ending March 31, an annualised 6.9% over 10 years and 7.5% for 20 years of exposure.

This move by CalPERS comes at a time when returns from private equity have been questioned. But Frost is unfazed, noting that despite this, she and CalPERS are confident in the process they are undertaking.

Some opportunities exist in private equity following the collapse of Silicon Valley Bank, she said, adding that the fund is ready to deal with the risk to gain from such a situation.

This comes after a mini-bank wobble which saw Signature Bank and First Republic in the US go under and Swiss lender Credit Suisse swallowed up by rival UBS.

This, for Frost, is an environment full of opportunity. "We have liquidity, we have a lot of dry powder that we can put to use," she said.

Indeed, it could well prove a good time for some investors to increase their private equity allocation. Some of the best performing private equity returns were generated after the dotcom crash and again after the global financial crisis, according to data from PitchBook.

CalPERS' bullishness for private equity comes after last year's revelation from Musicco that a decision to freeze its private equity programme between 2009 and 2018 had cost the pension plan an estimated $18bn (£14.5bn) in returns.

Musicco said its move in January was a greater commitment to private equity, which now offered a game-changing approach. "We welcome and encourage other global allocators to join us in this effort and reimagine the traditional and structural dynamics in the markets," she added.

Furthermore, Frost said CalPERS is eager to make further new investments into private equity, rather than using external managers.

Broader trend

For all the opportunities offered by private equity, it appears CalPERS is breaking with a broader trend.

When looked at as a wider movement, pension funds worldwide fell slightly short of meeting their private equity allocation targets in the first quarter, due it seems, to uncertain macro-economic conditions affecting institutional investment decisions, according to S&P Global Market Intelligence.

Among 365 global pension funds, the median allocation to private equity was $276m (£222.4m), compared with a median target allocation of $280m (£225.6m).

Investor hesitancy, according to S&P, was due to the uncertain direction of inflation and interest rates and the 'denominator effect,' which overexposed some institutional investors to private equity as public markets fell.

"Whether the slight under allocation represents a temporary adjustment to the current investment environment or the beginning of an allocation reassessment remains to be seen," S&P said.

The under allocation can be attributed to other factors. There was, for instance, a relative dearth of private equity and venture capital funds launched during the first three months of this year, compared to the same period a year earlier.

Only 30 funds launched worldwide during the first quarter raised more than $100m (£80.5m), down from 450 during the opening three months of 2022.

PEOPLE MOVES

Otto Thoresen is retiring as trustee chair of the **BT Pension Scheme** after four years of service. He will leave when the triennial valuation negotiations are over.

In response, BT has appointed **Jill Mackenzie** as an independent employer-nominated trustee director of the pension scheme with the intention of becoming chair in due course.

Mackenzie (*pictured*) brings trustee experience to the scheme, having spent seven years as a board member and senior independent director at Nest. Mackenzie also sits on the board of the Fidelity Master Trust.

LGPS Central, which manages around £28.5bn of assets for eight local government pension schemes, is looking for a new chief executive after **Mike Weston** decided to end his four-year reign at the pool.

Commenting on his departure, Weston pointed out on LinkedIn that he has taken a public position in support of further and faster pooling. "Sometimes when you take a position, not everyone agrees!" he wrote cryptically.

John Burns, LGPS Central's deputy chief executive, chief operating and financial officer, has been appointed interim chief executive, subject to regulatory approval, until a permanent successor is found.

In other news, LGPS Central has welcomed **Sheila Stefani** as its head of stewardship. She brings a track record to the pool of advising trustees on responsible investment policies and ethical frameworks.

Independent professional trustee specialist Dalriada has added almost 20 years of experience to its offering following the appointment of **Shehzad Ahmad.**

The senior trustee (*pictured*) joins from Ross Trustees where he was a director responsible for schemes managing between £1m and £3bn of assets.

Ahmad's pensions experience includes journey planning and leading restructurings as well as working on funding negotiations.

Elsewhere, **Best Trustees** has promoted **Ann Rigby** to chair of the board. She takes up her role at the end of June when Zahir Fazal steps down. Rigby joined the professional trustee specialist in 2013 and has sat on the board since May 2021.

Best Trustees has also hired former chief strategy officer of Smart Pension **Michelle Darracott** as a professional trustee.

Finally, **Capital Cranfield** has increased its expertise through hiring **Ray Pygott** as a professional trustee. Pygott has advised trustees and corporates through his work as chief actuary of KPMG's pension practice and a founding partner and head of trustee services of Isio.

CALENDAR

Topics for confirmed upcoming *portfolio institutional* roundtables:

June
– Biodiversity

June
– Outsourced CIO

July
– Net Zero

September
– Defined Contribution

October
– Fixed Income

November
– Sustainable Strategies

NOTICEBOARD

Railpen, the pension scheme for workers on Britain's railways, has bought a nine-unit industrial property in Cambridge. The financial terms of the deal to acquire Coral Park Trading Estate have not been disclosed. Tenants for the almost 50,500-sq ft asset include the Royal Mail, Halfords and Wolseley.

This is not the scheme's first property in Cambridge having bought Botanic Place, a 309,000 sq ft office development, last year. It also has retail and other office assets in the city.

Cambridge is favoured by Railpen due to its knowledge-led economy, it has sustained occupier demand and the local authority is supportive of sustainable development.

The British Steel Pension Scheme has become the largest retirement plan in the UK to fully insure all of its members.

The trustees agreed its fourth buy-in since November 2021 with **Legal & General** for £2.7bn. This final deal covers 40% of the scheme's liabilities and brings to total de-risking premium for the 67,000 members to £7.5bn.

Just, a retirement income specialist, has completed a series of pension scheme de-risking deals.

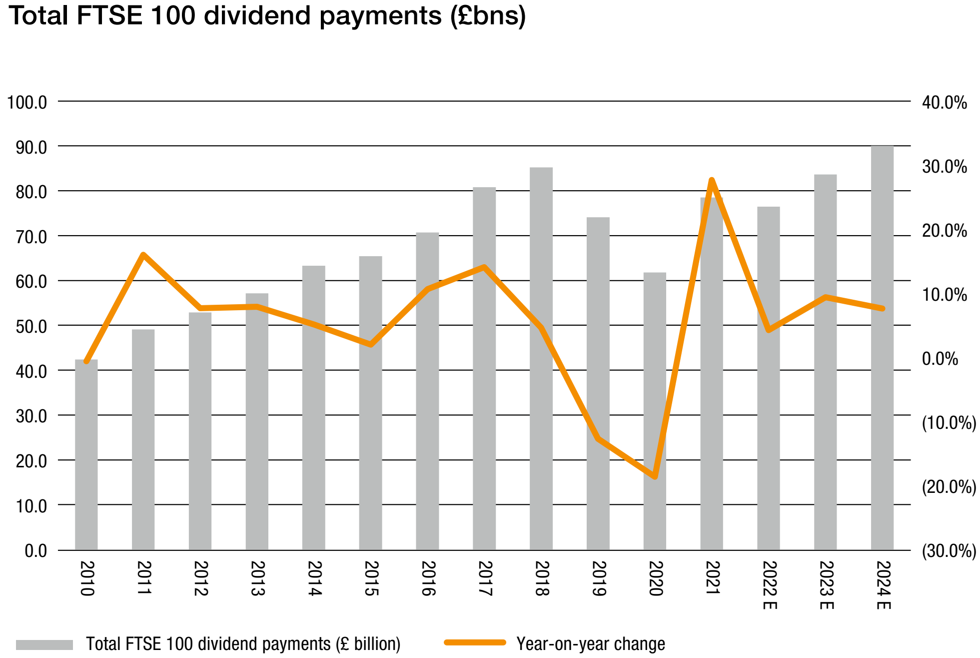
It completed a £34m buy-in with the trustee board of the pension scheme sponsored by cable supplier **Batt Cables.** The full buy-in secures the benefits of 193 deferred members and 71 pensioners.The deal was completed in December, but payment of the premium was partly deferred to give the sponsor the flexibility they needed.

Just also completed a full buy-in for the **Timpson Group Pension Scheme,** which is for the employees of retail group Timpson, which has shoe mending, dry cleaning and digital photography businesses among other retail services.

The scheme has 369 pensioners and 694 deferred members.

Just also insured the liabilities of all 111 pensioners and 149 deferred members of the BUT Retirement Benefits Scheme in a £40m buy-in. The retirement scheme for workers at Aviagen Turkeys will now proceed to buyout.

THE BIG PICTURE: FTSE100 SET FOR DIVIDEND BOUNCE



Source: AJ Bell from company accounts, Marketscreener and consensus analysts' forecasts

Blue chip dividends are set for a boost in the next 18 months, but from a smaller number of companies, reports *Andrew Holt*.

FTSE100 dividends are set for a substantial surge. The top 100 London-listed company dividends are expected to jump by 11% this year, says stockbroker AJ Bell.

That's not all. The dividends will continue to climb next year by another 7%.

Although this year's payments will not beat the ordinary dividend record set in 2018, next year's shareholder returns are expected to reach new heights.

AJ Bell expects 2022's ordinary dividends to come in at between £76.4bn and £81.2bn, rising to £85.8bn for this year.

Driving this outlook is an expected record year for pre-tax profits from the blue chip index. The forecast is looking at a 23% profit jump in 2023, setting a new record by handing back £279bn to shareholders.

The expected impressive dividend rise comes despite nagging recession fears, which seem to recede by the day. There is also a banking wobble, although AJ Bell notes that this appears to be more of an issue for badly run lenders in the US and Switzerland.Indeed, it is in banks, and financials more generally, which are the key drivers for dividend growth among the FTSE100's constituents in 2023.

Banks are expected to distribute a whopping £14.6bn to investors this year. A figure higher than the £13.3bn peak seen in 2007 – prior to the financial crisis.

Yet the big dividends are condensed among a small group of companies with just 10 stocks forecast to collectively return £46.6bn, or 55% of the forecast total for 2023. And the top 20 are expected to generate 73% of the FTSE100's total payout at £62.1bn.

HSBC is forecast to be the single biggest paying FTSE100 stock in 2023, with the usual suspects of Shell, British American Tobacco, Glencore and Rio Tinto next on the list.

That said, history suggests that it is not the highest-yielding stocks which prove to be the best long-term investments. The strongest long-term performance often comes from companies that have the best long-term dividend growth record, as they provide the dream combination of higher dividends and a higher share price.

Con Keating is head of research at Brighton Rock Group.

INFLATION: THE BRITISH ISSUE

Against a backdrop of geopolitical and economic uncertainty, which is unprecedented in my 50 years of market involvement, I shall focus on just one UK domestic issue – inflation.

Since the release of the latest CPI figures, no end of talking heads have delved into the entrails and one central point has emerged. Core inflation is proving very sticky. It is not declining as rapidly as was hoped or priced by markets and remains much more elevated than in the other major developed economies. This latter aspect may be, in part, an effect of our post-Brexit world. This bout of inflation has its roots in the response of the Bank of England to the early pandemic 'dash for cash', and another large round of quantitative easing (QE). While the earlier rounds of quantitative easing had driven up asset and house prices, this had not extended to prices more generally.

This may explain the Bank of England's rather strange stance with the Treasury Select Committee, which was to say that the roots of today's inflation were not monetary in origin but could be resolved by monetary policy. The difference between these periods is that post the global financial crisis, the economic problem was a lack of demand while now it is a shortage of supply. It would appear that further rate rises are now to be expected from the Bank, and that contrary to the IMF's prognostications, a recession in the UK is a distinct possibility. The reversal of QE, quantitative tightening, brings with it a risk that was not present in the earlier phase. As Raghuram Rajan pointed out in his August 2022 Jackson Hole speech; the commercial banks large levels of reserves are reflected in large levels of retail demand deposits and corporate lines of credit, and as they are run down or utilised, liquidity strains are likely to appear. We have seen with Silicon Valley Bank how these strains may escalate with disastrous consequence. Inflation increases the likelihood of such events.

Liquidity in markets

The liquidity aspect of the gilt market turmoil witnessed in September last year and liability-driven investment has received a lot of attention, but in all too many cases the analysis is poor as it lacks detailed analysis of the mechanics and as such is superficial, or worse, it is just pure opinion to defend some prior position which the empirical evidence simply does not support.

It is important to understand that liquidity has a cost; that there is a price for liquidity. It is not some innate, binary property of a security. Its price is strongly procyclical. For a security or class of security, it is adversely affected by the degree of concentration of its ownership. This was a real problem for index-linked gilts, with 80% or more of them being held by UK pension schemes. In the period prior to 2021, this manifested itself in ever higher prices and real returns as low as RPI minus 3.2% in the 10-year maturity. Then, in the crisis, we saw price declines of more than 80% in long-dated linkers and real returns shifted from RPI -215 basis points, to RPI plus 210 basis points. One of the aspects of the crisis which has gone largely without comment is that some schemes were large active sellers of other securities in order to buy index linked and conventional gilts. This activity was responsible for most of the low net sales of linkers and conventional gilts reported. The repatriation of overseas sales proceeds was also a significant contributor to the strength of sterling after September 26, 2022. It is a cruel fact that the most resilient investment class during the crisis was emerging market debt.

Final thoughts

It is clear from the valuations and reports of many pension schemes that have emerged during the past few months, that the full costs of the LDI crisis have not yet been realised, and that many schemes still need to be rebalanced. According to the latest monetary statistics (M4L), debt has been reduced in segregated accounts and pooled funds, respectively by £20bn and £55bn, but there is clearly much further to go, particularly given the new buffer requirements for pooled funds.

One final observation is that index-linked gilts are in fact poor hedges of the inflation exposures of UK defined benefit schemes. That said, with real returns now in excess of 1% above RPI, they may well prove to be the safest of havens and offer the highest returns to unlevered investors in these troubled times.

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PENSIONS AND INVESTMENT IN THE UK ECONOMY

In the month the PLSA hosted its annual investment conference in Edinburgh, *Nigel Peaple* outlines the topics that matter most to the pensions industry.

A debate about how to harness UK pension assets to drive growth in the British economy has heated up in recent weeks with the Chancellor of the Exchequer to the Lord Mayor of London lamenting a perceived lack of investment by the £2.5trn UK pension sector in high growth, but high risk, venture capital assets.

We should not lose sight of the fact that our pension schemes already invest more than £1trn in UK-domiciled shares and bonds and have a higher domestic equity exposure than some of their giant overseas pension counterparts, including those in Canada, Japan and the Netherlands.

Nevertheless, pension funds are open to initiatives that would result in greater investment of pension assets into UK growth, provided that the needs of savers, pension funds and the government can be aligned.

At this year's conference, economic secretary to the treasury and city minister Andrew Griffith MP discussed the government's ambitions to unlock pension scheme investment in UK growth assets, while a further keynote saw a panel of leading chief investment officers discuss the challenges and opportunities from doing so.

Path to net zero

UK pension schemes are increasingly making progress towards net-zero alignment, with six in 10 already having a net-zero alignment in place.

Of those that don't, this is largely to do with the difficulties of comparing like-for-like data received from investee companies and wanting to ensure their commitment is robust.

Pension schemes have called on the government to progress its green finance strategy, finalise the UK green taxonomy, ensure climate reporting is embedded across the investment chain and accelerate efforts to make the City of London the world's first net-zero financial centre.

At Investment Conference 2023, former shadow chancellor Ed Balls discussed how a future Labour government would harness the power of pension investment to support the transition to net zero. Delegates also heard from experts about how to integrate climate risk, transition risk and scientific research into asset class return projections, as well as practical advice about completing TCFD reports.

A panel of pension fund investment managers also explored how pensions can support the decarbonisation agenda while avoiding unintended consequences.

A new environment for DB funds

At this year's conference there was a significant focus on the changing landscape for defined benefit pension funds.

Higher interest rates have improved funding positions and opened the door to buyout for many schemes. The conference explored the key issues schemes need to assess in their endgame thinking. From the pros and cons of moving to buyout, the need for residual risk cover and avoiding traps in the transition to endgame.

We also took stock of liability-driven investment in the wake of the "mini" budget and gilt market turmoil last year. Schemes of all sizes are re-thinking scheme governance, asset allocation and portfolio reconstruction.

Sessions also looked at what lessons have been learned, how schemes should manage risk and what governance structures they should have in place for the future.

Also, high up on defined benefit funds' priorities is the DB Funding Code. Experts discussed what the final code might look like and how it will be applied once it becomes operational later in the year.

Investing in a challenging economy

Fresh stagflation and recession fears mean the challenging investment conditions of the last decade are not going away any time soon.

In what is frequently one of the most popular sessions at the investment conference, senior representatives from asset managers provided an outlook on investments and opportunities for pension funds. They explored the opportunities and risks across different asset classes as well as inflation protection measures.

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INTERVIEW – PADMESH SHUKLA

"Good governance has been the stepping-stone to everything we have achieved in the past 10 years."

The chief investment officer of the TfL Pension Fund sits down with *Mona Dohle* to discuss home bias, the benefits of alternatives, believing in developing markets and emerging from the LDI crisis like a winner.

You have been with the TfL Pension Fund for more than 13 years. What has changed during that time?

Perhaps it might be better to ask what hasn't changed? Our strategic asset allocation has seen a complete sea change. It is now much more globally diversified.

Then there is the governance of the fund, which has gone through a complete refresh. A lot of great work has been done here by our fund secretary, Stephen Field. Good governance has been the stepping-stone to everything we have achieved in the past 10 years. It has allowed us to have much greater in-house resources and capacity and to take greater control over our destiny and how we work with our advisers and key stakeholders.

Like many other pension funds, we have made a conscious decision to address our home bias as part of building a more robust portfolio. Our allocation to the UK across all asset classes was 60% at one time, but is now down to around 8%, excluding our UK linkers and around 20% with them. That shows how big the change has been and how outward looking we have become as a scheme.

Unsurprisingly, sustainability is now fully embedded in our investment framework. In 2010, not many of us had heard about climate change, let alone net zero. Sustainability and climate change is now the third axis of our investment strategy.

Finally, we had £4bn in assets back then; we have nearly £14bn today and are fully funded on technical-provision basis.

Why are you reducing your equity exposures in favour of alternatives?

Our key focus has been diversification with a clear focus on downside protection and risk management more generally. I'm sure that was always the case, but we are now thinking much harder about the return premiums and how we can slice and dice our strategy to be more diversified by economic environment, geography, sectors, style and themes.

That means our allocation to equities is down to 35% from a high of 65%. And in that bucket, the UK that once made up almost 60% of our equity allocation, is now more like 4% to 5% in line with our now much more global and diversified focus.

Our reduction to equities has been matched by an increase in allocation to alternatives, jumping from a low single digit to more than 40% and rising. Building a robust alternatives portfolio and reaping its benefits has been the real story of my fund, my trustees and my time here.

These changes cut right into the debate of should British pension funds invest more in UK equities. Why have you chosen not to do so?

As a pension fund, you must be aware of home bias, as I noted before. The UK's share of the MSCI World has fallen during the past 10 years to about 4%. It has gone up slightly in the past 12 months but only marginally, so our allocation to the UK is in line with the benchmark.

Most of this is in actively managed mandates. We are not telling managers which market to choose. If they feel that the UK offers good options, they will allocate capital. That has always been the case. If I look at our value managers, they are over-allocated to the UK versus other markets and we have benefited from that.

What I am not suggesting is that as a UK pension fund, we are having an overt tilt towards the UK. Home bias should always be on our minds and an allocation should be a function of opportunities based on the risks and returns the markets offer. At one stage, the UK was quite attractive on a valuation basis, but our trustees are not looking to over-allocate to the UK just because we are a UK pension fund.

We also must be aware of Transport for London's covenant risk with its high UK/London economic dependency. From a funding perspective, my trustees are quite mindful of diversifying against this risk as much as any other.

What alternative asset classes is the fund focused on?

TfL Pension Fund has one of the largest allocations to alternatives among our peers at about 40%. Private markets are around 28% and liquid alternatives – which are primarily hedge funds and low-cost absolute return strategies – are around 12%. Within those two broad categories, we are invested in almost every segment of the market.

Within private markets, about 9% of our fund is committed in infrastructure, 5% in real estate, 11% in private equity and nearly 5% in private credit. In the majority of cases, we are at or near our target allocation, but we are continuing to scale up these strategic asset allocation targets. This is driven by our search for diversification, downside protection and desire to clip illiquidity premium in private markets.

We are a defined benefit scheme, but are still open and overall cashflow positive, so we can afford to take the long-term view required to invest in private markets.

Every alternative asset class is different and is there for a good reason in our portfolio. Assets like infrastructure are return-seeking, liability-matching investments. Private credit – investment grade and sub-investment grade – complements our public bond allocation.

Our hedge fund portfolio is probably the most interesting and unique in our peer group, many of whom have exited this asset class. Our portfolio has a low correlation to equities, rates and credit. It is there purely to diversify the classic market risks, of which we had all in plenty last year. Depending upon which markets you held, your assets could be down by as much as 20% to 25% last year but our fund was flat for and I have our hedge fund portfolio to thank for that, while some funds returned as much as 50%. That showed the value of diversification.

We have never held highly levered long-short equity managers. Instead, the focus of allocation has been on risk-controlled macro, commodities and trend strategies that benefited from volatility last year.

Should the DB Funding Code consultation result in a greater distinction between the investment strategies of open and closed schemes?

There must be a distinction between open and closed schemes. Our needs are different from those of a closed scheme.

One-shoe-fits-all can't be the right approach for our sector. That would certainly limit the options and the tools open schemes would have to deliver the returns needed. So the consultation should take into account the nature and needs of open schemes and our response to the consultation makes that point.

Why do you have a significant investment in emerging markets?

Emerging markets are quite close to my heart due to my connection to India and my years at the World Bank. Putting my preferences aside, it is the trustees who drive these important allocation decisions for the fund.

I have a couple of observations on our approach to emerging markets. First, it is consistent with our view on diversification as we expect EM countries to have a better long-term growth trajectory than the developed markets and different growth drivers.

Second, we have had a consistent policy of over-allocation to emerging markets versus the benchmark for more than 10 years because of our long-term investment focus and belief in these markets.

Third, we cast our net widely with an allocation to every possible emerging market sleeve. This includes private equity, equities, bonds, infrastructure, real estate and hedge funds. The only thing we haven't done is private credit and that is not for the lack of trying.

Fourth, we have not shied from making bold and innovative moves. We were one of the seed investors in the IFC Emerging Market Fund back in 2014 when infrastructure was not even a mainstream asset class, let alone one focused on EM.

I engage with the IFC Asset Mobilisation team to explore investment opportunities in the low-to-medium countries to address climate change and deliver the Sustainable Development Goals more generally. On that theme, last year we made a $50m (£40.1m) commitment to a large greenfield solar platform in Brazil. We invested in renewables in India and China long before many pension funds were investing in their home renewables markets.

Of course, there is a perception that these are risky assets, and I'm not denying that. The important point here is to understand that they offer attractive risk-adjusted returns.

I have two related observations. We are firm believers in active management, as investing in emerging markets cannot be done passively.

The other is that there is a critical link between our sustainability and engagement strategy and investments in emerging markets. This is an asset class where our fund sees most value-add from engagement and impact delivery, not just on climate change but on multiple sustainability metrics.

What percentage of your entire portfolio is allocated to emerging markets?

We are roughly 2% in excess of the benchmark so about 12% of our equity allocation and around 8% overall. This is tiny compared to their economic footprint of around 60%.

With interest rates rising, are you concerned about further sovereign debt defaults?

Emerging markets is just one broad label. Within that label, at one extreme we have countries like South Korea and on the other side of the spectrum we have Mozambique, for example. The difference couldn't be more immense.

This is why it is important that emerging markets are approached with caution and through active management.

We have default risks in our fixed income book. You can't completely avoid them, but it is so important to be with an active manager in emerging markets who understands the economic and political dynamics to avoid the falling knives.

Some will offer attractive headline returns but there is a reason for those returns. Actually, if you look at some of the well-constructed frontier market portfolios, risk-adjusted returns are better, but not having a concentrated position is key.

The perception of risk in emerging markets is always greater than the reality with a tendency to extrapolate risks on the back of more idiosyncratic events, be it default by Sri Lanka or Ghana, as an example. The way I see it, this perception premium allows for some attractive risk-adjusted opportunities, if harvested properly.

The fund also has a liability-driven investment strategy. How did that play out last year?

Like many pension schemes, our trustees have had an LDI overlay profile since 2010 with a range of triggers in place. So early last year, our hedge ratio was in single digits in conjunction with our real rates triggers.

The trustees understood the rates and inflation needed to be hedged but they had to take into account the open-ended nature and long-term focus of our scheme as well as value for money considerations. It made no sense to hedge real rates as low as -4%. So when the LDI crisis hit last year, we were in quite a comfortable liquidity position with a collateral buffer of as much as 800 basis points within the LDI mandate and ample cash liquidity outside at the fund level.

Many schemes struggled but overall, our liabilities were down, assets held up well and our funding ratio improved significantly, so I can only say that we have been a net beneficiary of the LDI crisis and a general uptick in real rates.

Is that also because your cash reserves allowed you to enter the bond markets when some assets became more attractively priced?

Absolutely. Things have changed since, in terms of hedging and leverage. Real rates increased significantly, and our trustees took the view that they had become attractive enough to lock in.

Actually, we have increased our hedging by a significant margin to lock in the benefits we have seen on our liability side, and it seems that we are again going against the crowd. We didn't hedge when others were happy to do it at almost any price, and now that the price is right, we have upped our hedging ratio when others are trimming or are unsure.

In those past 10 years, when real rates were down and falling, it is not that we forgot about hedging but that we focused more on proxy LDI assets such as infrastructure, UK PFI investments and renewables to some extent.

We bought these proxy LDI assets at attractive levels to build our hedges, but since September shifted our focus to classic LDI hedging using traditional LDI instruments. In a nutshell: we have ended up in a much better position post the LDI crisis.

Is this ambition to lock in the gains also based on an assumption that interest rates may have peaked?

Who can predict rates? Where they are today are not too far from the triggers we established years ago. Depending on which duration one wants to choose, rates are fairly well priced and consistent with our long-term assumption, so it makes sense for us to increase the hedge ratio.

By how much?

We were in single digits but now we are in material double digits. We are also quite mindful of liquidity risks and are maintaining healthy collateral buffers. We don't know where the rates might go from here, so have to be prepared for all eventualities.

Timing the market is always a dangerous game, isn't it?

Exactly. We only wanted to time it the moment it aligned with our long-term return requirements and real rate assumptions. We are not trying to time it tactically but it was getting quite difficult when real rates kept falling.

But increasing your hedges at this time is quite bold?

I wouldn't call it bold; I would call it prudent risk management which is consistent with our long-term beliefs.

You have ambitious interim targets to reduce the carbon in your portfolio. How is that going?

We have definitely been bold here. Our target includes a 55% reduction by no later than 2030 and 100% no later than 2045. This applies to our entire portfolio, including alternatives, which are the trickiest assets to decarbonise.

These are early days for our equity and bond portfolios where the carbon footprint is down by 35% and 33%, respectively, compared to our 2016 baseline, improvements that are well ahead of the reductions seen in our benchmark. So more is required, but things are going in the right direction.

Generally, our green investments are up from nearly nothing to close to £250m. Again, it's not just about what you shouldn't own, but about what you should proactively own. My trustees strongly believe that it is as much about investing in the opportunities in the transition space as it is about risk managing climate exposed positions.

If I look at our fossil fuel exposure, the trend is down but last year it was up on the back of a strong price rally, so there is some way to go here, but in a considered and responsible way.

One thing I keep thinking about, and it applies to all pension funds, is that 10% to 15% of our holdings contribute 80% to 90% of our carbon exposure. These are energy-intensive sectors.

We know where the problem is and that is where the opportunity for engagement is. We don't want to sell the assets and see them falling into less responsible hands.

We are trying to achieve two things: one is to reduce our allocation to companies that are not willing to change. The other is to increase allocation to companies and asset classes which are part of the solution. For both, engagement and collaboration are an important part of our toolkit, but they can only be deployed if you stay invested.

Finally, what do you expect to see in the markets during the remainder of 2023?

Clearly 2022 was a huge challenge. Inflation surprise was the real villain, crushing almost every asset class. We have definitely reached peak inflation, but what I'm not sure of is that we are anywhere close to what the central banks would love to have, which is inflation at 2%.

Markets have priced in that rates will tail off and then fall, but the economy and earnings would remain okay. There is this struggle in getting the right balance between rate hikes and inflation without killing growth. That will be the main problem for this year and some of the market expectations on rates, inflation and growth are premature and over optimistic.

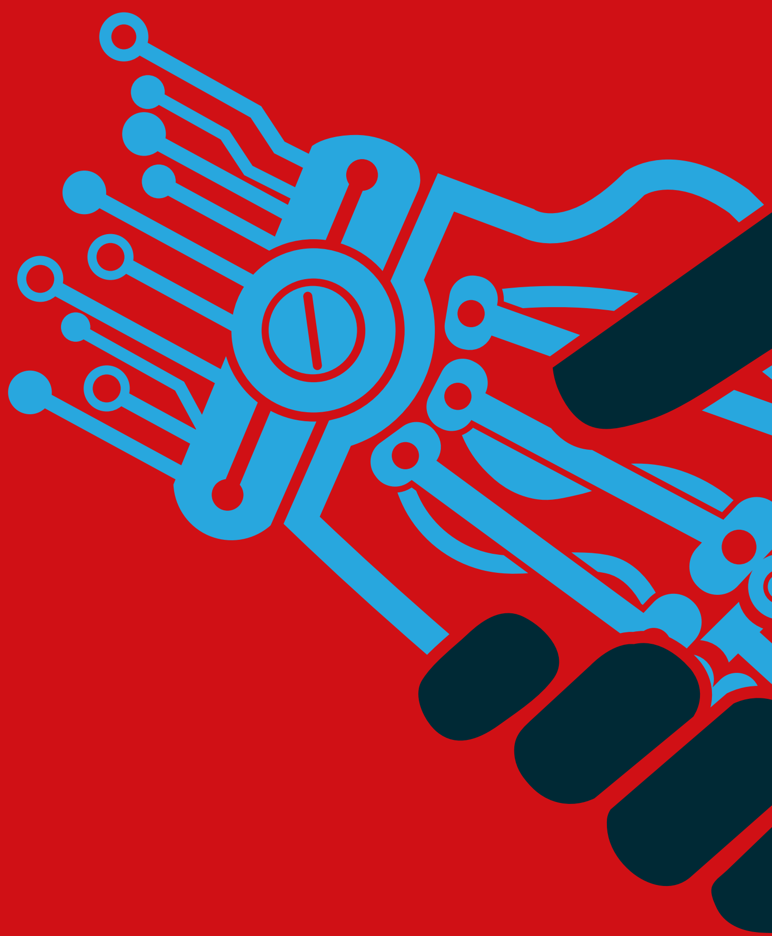
Some investors are starting their celebrations a bit too early. I hope I'm wrong and they are right, but we have to be mindful that the risks remain quite real.

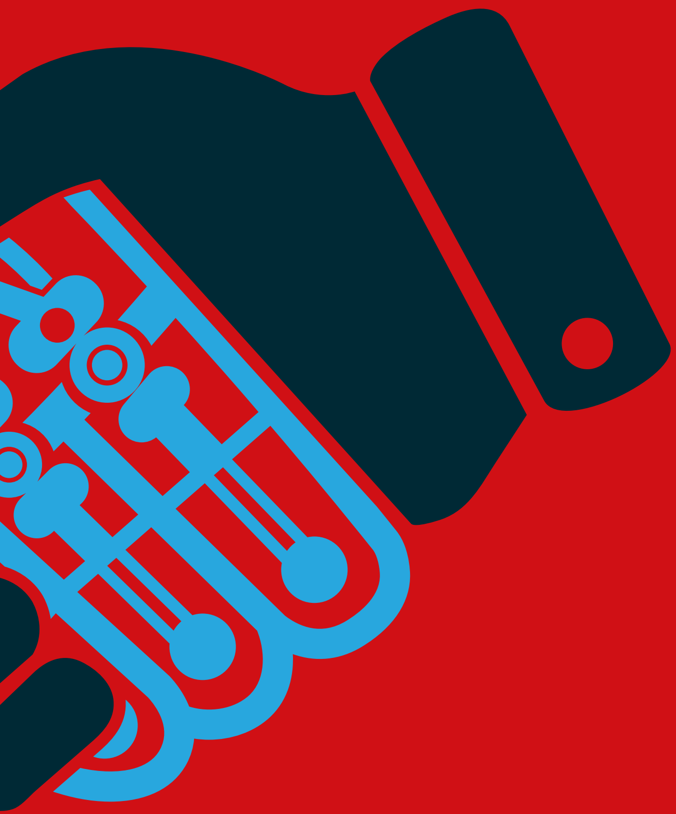
What does this mean for pension funds?

We tend to think in decades. And the past 10 years were exceptional in terms of returns. It ranked right at the top investment decile on any metrics. But the next 10 years will not be anything like that. The world is different with geopolitics and supply chains a lot more disconnected, and many secular tailwinds risk becoming headwinds. That means we must be even more mindful of diversification and risk management.

The good news is that many schemes and endowments are in a good funding position, so at least we are starting the next 10 difficult years on a strong footing and therefore don't need to take as much risk as we would have taken in the past decade and be handsomely rewarded for it.

AI: INTELLIGENT INVESTING?





Artificial intelligence is predicted to revolutionise many aspects of our lives, but how could it benefit institutional investors? *Andrew Holt* takes a look and discovers that the human factor is key.

One theme being covered across all media everywhere is that of artificial intelligence (AI). The Competition and Market Authority, a regulator, is investigating AI. Its impact is set to be as big as the industrial revolution, former government chief scientist Patrick Vallance has said, while US President Joe Biden has made it a priority to encourage big tech bosses to make AI safe.

Indeed, safety concerns usually dominate conversations on AI, with much coverage often accompanied with the vision of Armageddon and the mandatory pic of Arnold Schwarzenegger dressed as the Terminator to illustrate the point that AI could lead to nothing but darkness.

Even the chief executive of AI specialist OpenAI, Sam Altman, acknowledged the concerns over AI during an appearance at a US Senate sub-committee hearing in May. He went as far as calling on Congress to create licensing and safety standards.

OpenAI is the company behind ChatGPT – an advanced AI chatbot which can make human-like conversation. It is a bad day when one of your own innovators questions the validity of what is happening in the AI space.

But there is another narrative, albeit one that is drowned out by the noise around the dangers of such an innovation: one in which AI contributes to the overall good, providing a pathway to progress and offering numerous benefits along the way.

To get to grips with AI, Martha Lane Fox, a technology guru and president of the British Chamber of Commerce, calls for more understanding on the impact and importance of AI. “You need to get educated about it as an individual. Whether you are a business leader, investor, work in a charity or in the public sector, it is going to impact how you do your job,” she says.

Three stages

This raises big questions about what it could mean for the investment industry. Given its prevalence everywhere else, it is not surprising AI is being discussed in such an arena. And it seems, on an initial view, that asset owners find AI appealing.

That is if a CFA Institute Investor Trust Study is a suitable guide. This found that 84% of institutional investors want to invest in funds that use AI and a similarly high level (78%) believe that the use of AI in investment decision-making will lead to better investor outcomes. This appears a pretty unequivocal endorsement of AI from investors.

But this is far from the full story. Although investors are positive about AI, how they are approaching it is far more complex.

Larry Cao, senior director of research at the CFA Institute, reveals that further surveys give a more in-depth look at how investors are embracing AI. Or rather, how they are not.

“We believe AI adoption amongst investors is a progression,” he says. “There are those not doing anything on it. That bucket accounts for about 30% to 50%.”

This indicates that while investors find AI appealing, the level of commitment is open to question. In fact, Cao highlights the three stages of AI adoption that investors are following.

The first is at an early stage: when investors are doing something, say within one geographic area or one functional department.

The second, a more intermediate stage, is more sophisticated: one where investors have a more strategic approach to the issue of AI, while using a greater co-ordination between investment functions.

Then there is the more advanced stage, where all investment functions, strategies and geographies are using AI.

“We see few [investors] in the advanced stage,” Cao says. “We also see few in the intermediate stage. In total, for both we are talking about 20% [of investors].” When looked at in this way, AI presents an option for a small number of investors.

With most investors sitting within the experimentation phase of AI, this probably should not be a surprise, given it is such a new technology. Explaining what is happening here further, Cao adds: “A large number are experimenting with AI in different ways. That is where the bulk of investment organisations are, making a chunk of about 40% to 50%. We do see numbers inching up, but it is a gradual process.”

Different beasts

Endorsing this picture of a gradual growing interest, Federico Invernizzi, chief operating officer at AI specialist MDOTM, says asset owners are showing an interest in AI, but have particular requirements. “It is a little different, given that they are a different beast from an asset manager,” he says.

> **We believe we are in the springtime for AI and looking forward to an impactful summer.**
>
> Robbie Henderson, Newton Investment Management

He then lists asset owner requirement in regard to AI. "They are more interested in portfolio analytics, asset allocation and funds selection, which AI can assist with, but, of course, it needs customisation and you need to understand it is not about adding AI per se but more what they are trying to solve."

There are other points of focus for asset owners. "Typically, you end up looking at longer time horizons, fewer asset classes and a little more alternative assets," Invernizzi says. "So it changes a little from the point of view of asset owners [versus asset managers]. But yes, there is a lot of interest from asset owners."

Lorenzo Saa, chief sustainability officer at Clarity AI, a sustainability AI platform, agrees, saying that asset owners are showing a "cautious excitement" towards AI. "We have a client base of asset owners who are certainly keen to leverage the power of AI," he adds. "They often come to us with a desire to know more about how our team of experts – data scientists and sustainability experts – work not just with the AI, but as the masters of the AI, those who are in charge of it."

Net zero

In his discussions with asset owners, one example he has seen resonate is around the use of Natural Language Processing, or NLP. This is used by Clarity AI to measure the quality of net-zero transition plans at scale in an automated fashion by identifying whether they contain all the necessary elements. This effectively allows asset owners to scale the evaluation of transition plans across entire portfolios and for a better forward looking view of how their holdings are likely to perform in the future.

Returning to the three stages of progress in AI, Cao believes the intermediate stage could prove to be the most popular option for investors going forward. "This means investors use AI in some of their core functions, and correlation across functions across business units and geographies."

But this does not mean AI will be rejected – far from it. "AI will be a differentiator," Cao says.

The benefits in differentiation may well present themselves more to asset managers, than asset owners, says Axel Maier, a partner at MDOTM. "Financial institutions that can successfully leverage this new technology and platforms will be more likely to grow their market share, launch new innovative products and enhance the results they deliver to final clients," he adds.

But like much of AI, the differentiator picture it is not a simple trajectory of success. "As AI progresses, there will be winners and losers," Cao says. "The winning organisations will be those that fully embrace AI plus human intelligence (HI). You need the investment expertise and then use AI to scale it up. This is therefore not using AI to take over the investment world."

Digital transformation is the hottest topic when speaking with business leaders in any industry, and this is no different with pensions.

Neil Mason, Surrey Pension Fund

AI meets HI

This is a crucial point. One in which AI works best when combined with HI: the best, essentially of man and machine. "The winning organisations will be a smaller number but will focus on that split between AI and HI," Cao says.

When I ask what AI offers asset owners, Lorenzo Saa has a similar logic mix of AI and HI in his outlook. "Think about it like chess. AI beats humans, but AI plus humans beats AI," he says. "The reasons the two are better together is that there is certainly a competitive advantage to using advanced technology to gain efficiency and scale, but using AI alone would limit the ability to strategically predict what will happen in the future."

Working on this theme, Saa adds: "Thinking many, many moves ahead is something AI plus humans will win at when pitted against AI alone. Future-forward thinking is exactly how asset owners invest for the long-term," he says. "That's how our team of data scientists and sustainability experts are designing our solutions and thinking about the long-term."

There is a responsibility to look at how the here and now affects the long-term, Saa says. "Not using AI doesn't make sense, but again, not using AI plus humans really doesn't make sense.

"Asset owners, and everyone else, should want and get the benefit from the best of both worlds – and that's in the combination of AI, governed by humans."

> **Think about it like chess. AI beats humans, but AI plus humans beats AI.**
>
> Lorenzo Saa, Clarity AI

AI in springtime

So the consensus has it that the mixture of AI and HI is central to bringing the best out of AI from an investment viewpoint. "We believe we are in the springtime for AI and looking forward to an impactful summer," is how Robbie Henderson, global research analyst at Newton Investment Management, colourfully puts it.

"The deep learning paradigm shift is central to this view," he adds. "Deep learning techniques have long held the promise of fulfilling [Alan] Turing's desire for machines that can learn."

The two ingredients necessary in creating AI or learning machines, Henderson says, is incredible computing power and an abundance of data. "Moore's Law [on historical trends] has driven exponential gain in computing power and continues to do so," he adds. "In the past two years we have doubled the performance that was achievable. That sounds impressive, but what it really means is we have travelled as far in the past two years as we have in the previous 40."

And on the data aspect, Henderson makes a similar point. "The good news is we have lots of data. In fact, 90% of the world's data was created in the past five years."

Altogether, on these important parts of computing and data, it highlights the speed at which the issue of AI is developing.

AI predicts

And, of course, advocates of AI, often AI companies wanting to sell their wares, along with some asset managers, are not shy in promoting its benefits. One specific point is the ability of AI to conduct thorough investment analysis gives it better forecasting and predicting skills, compared to a human being. This, the argument goes, is particularly useful in addressing risk management.

AI also avoids the suggestibility of news cycles and market peaks and troughs. Although many institutional investors would retort they seldom are, given they furrow their own strategy or long-term objective.

AI also has the ability to make a dramatic impact on ESG investing – accounting for environmental, social and governance risks and opportunities in investing. And while AI can unearth key data for investors seeking sustainable investments, discerning unreliable information will be a key challenge, meaning humans will not be replaced any time soon.

But the shadowy part of AI is never far away. Martha Lane Fox warns that the threat from AI is real and needs big oversight. "We need to think at a supra-national level about this," she says. "Some countries will be developing this technology for nefarious purposes and could lead to a global AI arms race."

In such a scenario, the picture of Arnie as the Terminator returns, but this time, controlled by human activity.

The narrative of AI taking us into some form of future hell typically emanates from one place: the ethical considerations of AI, or the lack thereof. "There is a lot of research from the technological side about the ethics of AI," Cao says. "Data privacy and data governance are the major concerns."

He adds there is a simple way to avoid the problems that could emerge here. "Our view is the technology people should deal with the technology and ethics of AI, and investment professionals should deal with the ethics in investments," he says.

AI build

From this, Cao says there is an important point about how investment teams need to be specifically built to deal with the challenges of AI. He says the necessary skills come in the form of so-called T-shaped skills – made up of investment, innovation and technology expertise – creating an environment that has investment specialists and AI specialists.

"Not everyone is going to have T-shaped skills," Cao says. "You can have specialists on the team, but overall, as a team, they need to have T-shaped skills connecting AI technology with the investment professionals."

Such a team would only need to be a "handful of individuals", Cao says.

Many of the asset owners *portfolio institutional* spoke to said they were looking at AI but would not comment further. This endorses Cao's view that many institutional investors stand at the experimental stage. One that is doing so, in a little more advanced way, is the Surrey Pension Fund.

Neil Mason, assistant director and local government pension scheme senior officer at the Surrey Pension Fund, points out that he sees AI within a wider technology development. "Digital transformation is the hottest topic when speaking with business leaders in any industry, and this is no different with pensions," he says.

And Mason adds that there is a need to not only adapt to change, but the challenges connected to it. "There is no doubt that the 'art of the possible' is expanding rapidly with technological advances and no one can afford to sit still," he says.

"Dramatic headlines about AI and the roller-coaster ride surrounding bitcoin and non-fungible tokens make it difficult to make sense of how to progress and positively harness new tech."

AI transformation

But Mason concludes that it is ultimately helping to develop his, and the fund's, thinking. "In the Surrey pension team, we are at the start of a digital transformation programme which will specifically focus on how AI and automation can mechanise our service delivery function.

"We are fortunate that we are able to focus so explicitly in this area since many digital transformations struggle to identify target areas and spread their efforts too thinly. We are committed to resourcing our programme appropriately – another pit fall for others in the digital race – and will be working in close partnership with some of our key suppliers."

Some countries will be developing this technology for nefarious purposes and could lead to a global AI arms race.

Martha Lane Fox

Mason also notes the importance of up-skilling his team, in the way Cao highlights, while also again acknowledging the challenges. "We also know that we will need to up-skill our people and bring in specialist skill sets to help us with our journey. Attempting to gear up for the future in an environment where there is such rapid change is exhilarating and terrifying in equal measures. But we are buckled up and ready to start the journey," he adds.

But for many investors the issue of how AI will work as a useful investment tool can be difficult to comprehend. In an attempt to address the many grey areas surrounding AI, Deloitte has offered investors a route through the AI maze with a five-pronged approach in how to embrace it effectively.

AI tool

The first is to clearly define an AI strategy. This may sound simple, but it is important in articulating an understanding of how AI will be utilised as part of the investment model. A key part of this will be the need to evaluate the implications from a risk perspective.

The second is to determine the AI path going-forward. Here a so-called 'pilot, prove and scale approach' will demonstrate business value. Firms can start by identifying, evaluating and presenting options for creating value.

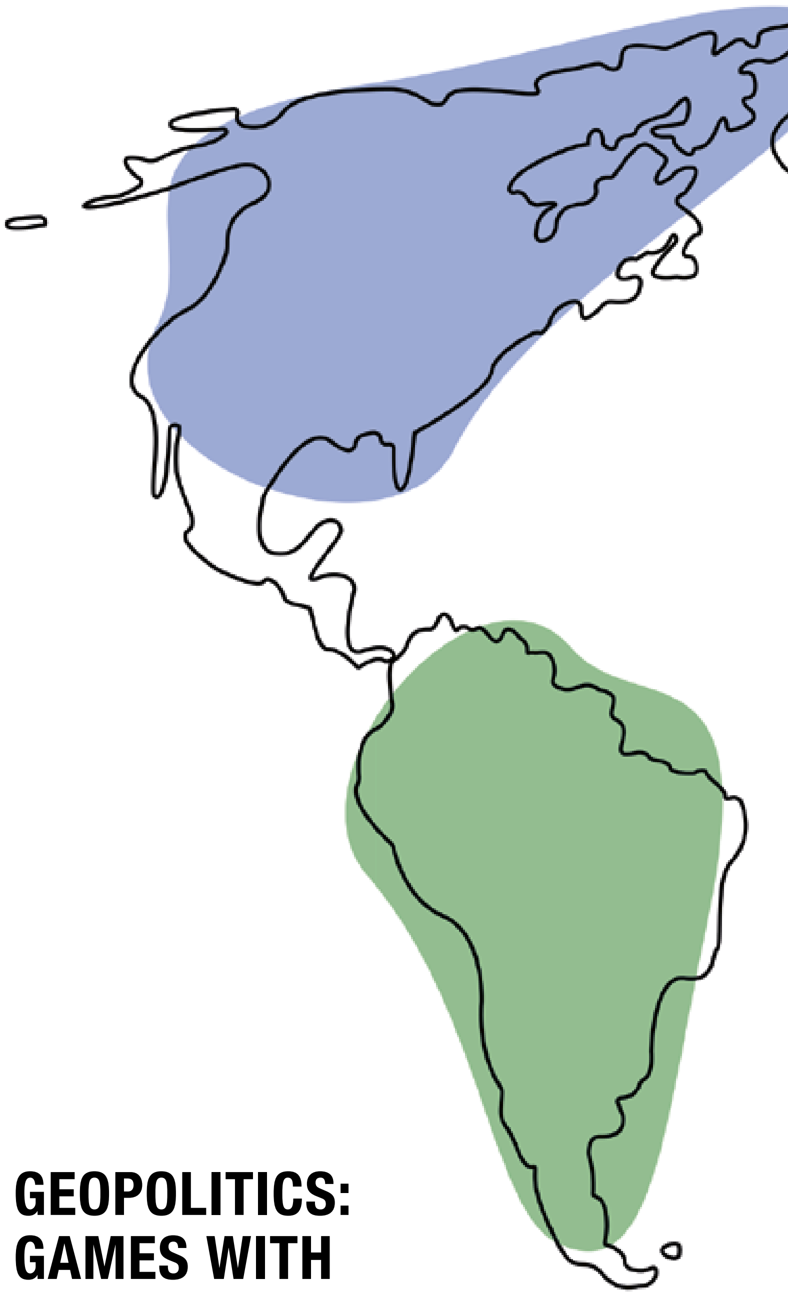
Third, is for investors not to be distracted from understanding and appraising the long-term implications of AI. And in so doing, make the appropriate investments in talent and technology needed for the transformation ahead.

Four, embrace strategic collaborations and partnerships to solve issues collectively and benefit from collective ideas, shared capabilities and investment. This will enable investors to sustainably develop differentiated products and services.

Five, work with industry stakeholders and engage with industry associations and regulators. As a successful wide-scale adoption of AI in investment management will require firms to work with a broad set of stakeholders. The issue here, it could be noted, is whether such groups are themselves up to speed on the issue of AI.

"The AI journey will undoubtedly be challenging, but the opportunities for investment management firms will be transformative," concludes the report.

Indeed, there are some huge forecasts on how big AI can become. According to McKinsey, by 2030 AI technologies will generate more than $3.5trn (£2.8bn) worth of value. PwC predicts a 14% boost to global GDP by the end of the decade, thanks to AI – a much welcome fillip for everyone, particularly investors. It is, therefore, imperative for investors to seize the opportunities this new technology offers. All the signs point to them doing just that, albeit at a slow and cautious pace.



GEOPOLITICS: GAMES WITH FRONTIERS

Last year was a perilous time for investors. Yet that tremulous market environment may not be a blip but the norm going forward. That is, if a theory around a geopolitical risk supercycle proves to be correct.

This suggests a 'supercycle' of geopolitical risk is in its early stages and so more market turmoil is on its way, with all the upheaval that it brings. This is a worrying prospect for many investors, although some will welcome the opportunities that volatility can create.

Evidence thus far suggests an analysis grounded on a geopolitical risk supercycle has much going for it. This is based on several converging factors that will shape the geopolitical and financial world going forward. It involves a comprehensive list of the emerging China-Russia partnership, NATO expansion, the Saudi-Iran diplomatic deal, US tech tariffs and industrial policy, a wave of global strikes and mass protests and the mega-election year of 2024 in many parts of the globe, creating mass uncertainty.

Tina Fordham, a geopolitical risk strategist who coined the 'geopolitical risk supercycle' phrase, says of it: "Based on 25 years of assessing the relationship between geopolitics and markets – there are few genuine 'black swans' and most risks are hiding in plain sight. If we don't see them, it's usually because we're either not looking or in denial."

Do investors see these risks in plain sight? Indeed, is the geopolitical risk supercycle theory valid? "The short answer is yes," says Richard Tomlinson, chief investment officer at Local Pensions Partnership Investments.

From the fall

The shift to a geopolitical risk supercycle scenario should be seen in a wider context of changes taking place in the global economy. This wider context, Tomlinson says, dates back to the fall of the Berlin Wall.

"Since the late 80s, we had on-going globalisation, global powers focusing on a peaceful world, essentially on the positives: with some of the poorer parts of the world getting better off and world poverty decreasing," he says.

But that is rapidly changing. The geopolitical risk supercycle outlook goes hand-in-hand with the idea of a new Cold War, according to a concept put forward by historian Niall Ferguson.

"The tectonic plates between China and the US have been changing. It is becoming more of a battle of pre-eminence, economic and military power," is how Tomlinson frames it.

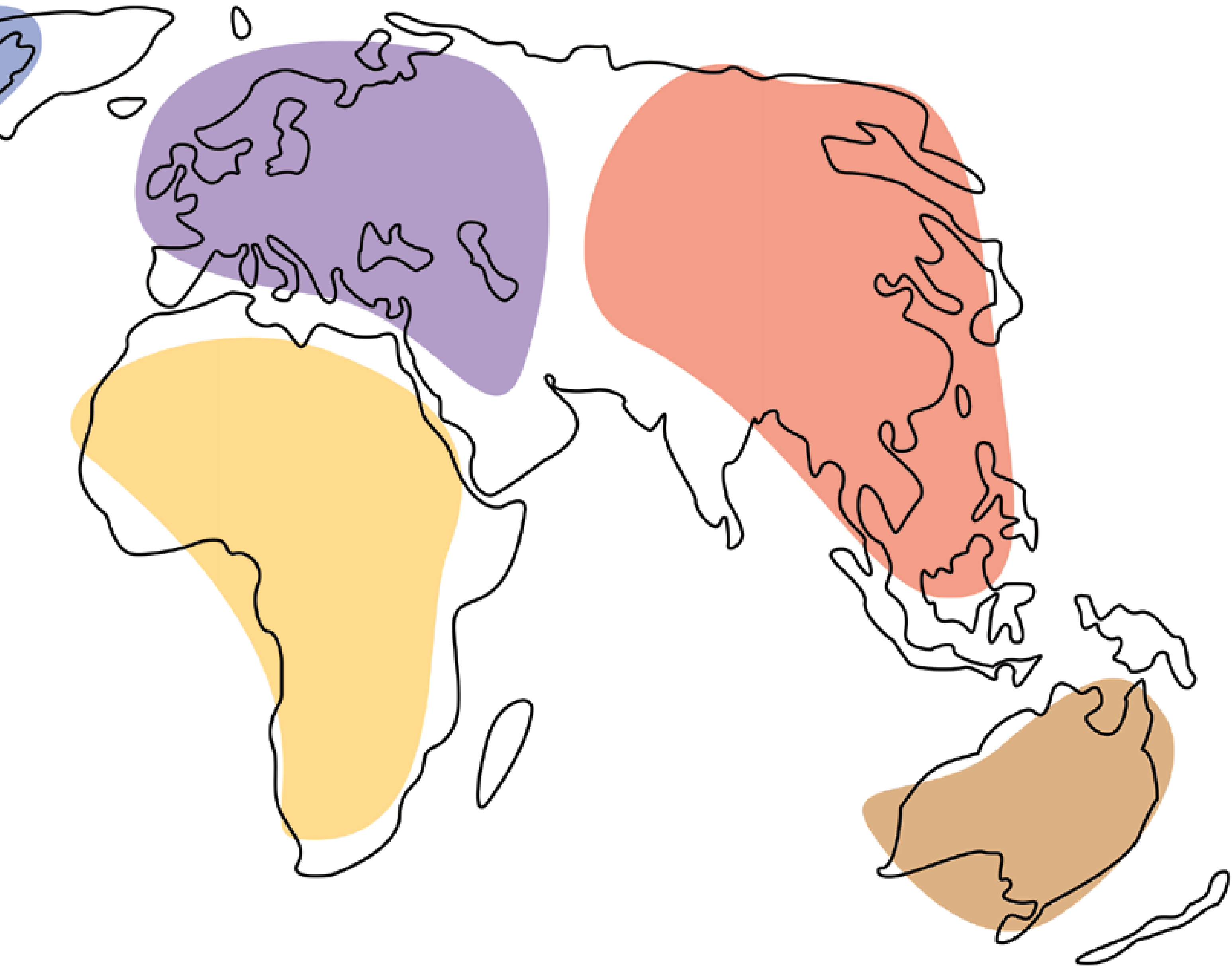
In the wider historical overview, the so-called Washington consensus that dominated following the Second World War, with the creation of the IMF and World Trade Organisation to govern the global economy, is no longer so dominant. "China is now saying: 'We are a superpower. We have a large economy and a large population' and [the declining Washington consensus] is an evolution of that important development," Tomlinson says.

New world order

Tom Donilon, chair of the Blackrock Investment Institute, puts it in starker terms. "We have entered a new world order," he says. "Two major geopolitical and economic blocs – one Western-led and one led by China and Russia – are firming up and are increasingly in competition with each other."

The fragmentation that's ensued, Donilon says, has led to a dramatic reduction in geopolitical co-operation and the rise of a group of more assertive and important multi-aligned countries.

This is reflected in the high ratings revealed in the Blackrock Geopolitical Risk Indicator, which tracks market sensitivities to



The world is going through political changes not seen since the fall of the Berlin Wall which could lead to a major rethink in how investors construct their portfolios. *Andrew Holt* takes a look at what could lie ahead.

geopolitical risks. The indicator keeps the US-China strategic competition risk rating at a high level. "We see the trajectory of US-China relations as decidedly negative and believe it presents significant risks for investors," Donilon says.

Tomlinson agrees. "The big relationship is the long-term evolution and relationship between China and the United States. Going back 10 to 15 years, there was a strong relationship between the two that worked – it had consequences, with US manufacturing hit hard – but there was a symbiosis there."

That isn't the case now. "There is a different political backdrop in the US and a different global situation," he adds. "America is deliberately changing its geopolitical role," Tomlinson says, adding that this is likely to have stark outcomes. "The world could easily divide into two power blocs, essentially amounting to authoritarianism versus democracy," Tomlinson says. The risk indicator also maintains the likelihood of high tensions in the Gulf also being a component part of the geopolitical risk supercycle. "The potential resumption of diplomatic relations between Saudi Arabia and Iran should support regional stability yet concerns over Iran's nuclear program have raised the risk of a military confrontation in the Middle East to its highest level in nearly a decade," Donilon adds.

And probably the most worrying assessment is Blackrock's high likelihood rating for a Russia-NATO conflict. "We see no resolution on the horizon as Russia and Ukraine pursue spring offensives," Donilon says. "We see a substantial risk of escalation in the most dangerous standoff between the West and Russia since the Cuban missile crisis."

> **We see the trajectory of US-China relations as decidedly negative and believe it presents significant risks for investors.**
>
> Tom Donilon, Blackrock Investment Institute

This is a stark assessment. And ramps up any geopolitical risk supercycle scenario to a potentially new, much higher level.

Getting colder

Unsurprisingly these risks are already rearing their head. They can be seen in the form of increasing structural headwinds, says Emiel van den Heiligenberg, head of asset allocation at Legal & General Investment Management. "These risks need to be viewed against a background of a deepening cold war between China and the US," he says.

The seeds of this are already appearing. Under the geopolitical risk supercycle scenario things are only likely to intensify. In fact, other themes connected to it could be seen as the much-debated issue of deglobalisation and arguments about the de-dollarisation to name but two, which are resulting in, or a result of, global power shifts.

It means ideas expounded by American political theorist Francis Fukuyama in the 1990s, in which he stated the 'end of history', resulting in victory for liberal democracy are speedily being put into reverse. Liberal democracy is not the victor, but potentially in retreat.

A clear indication of the uncertainty wrought by the geopolitical situation is evident by a 2023 political risk survey by Oxford Analytica. This showed that last year, 68% of global companies bought political risk insurance – providing cover for wars, coups, government expropriations and other risky misfortunes. This is up from 25% in 2019.

The fear from the geopolitical picture is revealed amongst corporations in other ways. Compared to last year's survey, respondents were far more likely to opine the worst-case scenario across geopolitical trend options.

The proportion who predicted deglobalisation would 'greatly strengthen' was 16% last year, but this has rapidly jumped to almost 50%. And the proportion who predicted decoupling from China would 'greatly strengthen' was 12% in 2022 but has since risen to 42%. These shifts are clear indications of where the global economy – with a strong reference to China – is going.

New era

What this means for investors is a clear re-assessment or even reconsideration of their portfolios. "The era is coming to a close when you owned multi assets and did not get hurt," Tomlinson says. "With the global risk situation, now it is how domestically you focus.

"That shock felt in supply chains is a factor, as is ESG," he adds. "It makes more sense to manufacture locally. It is almost like the moons are aligning for a more domestic focus."

So based on geopolitics, the environmental concerns and the overall balance of the economy in the UK, Tomlinson says this makes a strong case for domestic investments. "It is not quite levelling up, but it is thinking about how the UK evolves from here. Is it possible that we can invest in real assets that support the UK economy? Yes, absolutely," he says.

For Dan Mikulskis, partner at Lane Clark & Peacock, a consultancy, a revisit of asset owner allocations is much needed. "The fragmentation of the world economic system is something investors probably have to grapple with as they consider their capital allocation decisions around the world," he says.

As the big trend of the past 20 years has been asset owners diversifying portfolios out of home markets and into global markets, usually including emerging markets and especially China. "For asset owners in the UK, this has generally been a benefit in terms of returns," Mikulskis says.

A fragmented world

A huge re-think is needed. "Investors may need to reconsider the size of these allocations in a world which is more fragmented and where economic and financial sanctions might well be used which can trap capital or cause markets to close," Mikulskis says.

"Of course, it's also possible that markets may re-price to reflect these risks," he adds. "And some investors might consider them to be a suitable reward, whereas others might consider them too binary a risk to run."

Tomlinson also highlights a migration from financial assets to the real economy, with more focus on green infrastructure. "Then there are exposures that can survive different future world orders: US and Europe-based global corporations as well as real assets on the ground, the more robust conservative assets," he adds.

Wei Li, global chief investment strategist at the Blackrock

Investment Institute, says the situation demands more frequent portfolio changes by balancing views on risk appetite with estimates of how markets are pricing in economic damage. "It also calls for taking more granular views by focusing on sectors, regions and sub-asset classes, rather than on broad exposures," she says.

Although, as many commentators have observed with recent market shifts, it is hard to assess the degree to which geopolitical risks are priced into the market.

Long-term risk

Acknowledging the importance of the issue, Mikulskis observes that geopolitical risk is something investors will need to adjust to going forward. "One important thing to remember is that over the long term, living with risk and uncertainty is key to long-term investment growth," he says.

But Mikulskis adds a slightly different take. "In general, hedging risks, particularly broad and high profile ones like geopolitical risk, usually comes with specific cost in terms of lower returns. Many geopolitical risks have loomed large over the past decade while global stocks have overall delivered great returns."

In addition, geopolitical risk is difficult to sometimes fully assess based on three counts: it is difficult to forecast in terms of an overall outcome; timing; and the investment market outcome. "You need to get all three of those right," Mikulskis says. "And it's possible to get two out of three right, but still lose money," he adds, highlighting the challenge for investors.

Ineffective forecasts

Geopolitics is also a topic that attracts a high level of coverage, which is not necessarily a good thing. "Investors have a near-constant supply of forecasts – most of which will turn out to be wrong," Mikulskis adds.

TOP FIVE GEOPOLITICAL RISKS

1: US-China strategic competition
Issue at risk: China takes military action against Taiwan or asserts claims in the South China Sea by force.
Overall view: Military action not expected in the near term, but the risk could increase over time and subject to escalatory triggers.

2: Russia-NATO conflict
Issue at risk: Russia launches a large-scale invasion of Ukraine. The US and EU respond with financial, energy and technology sanctions on Russia.
Overall view: Russia's invasion of Ukraine is the largest, most dangerous military conflict in Europe since World War Two.

3: Global technology decoupling
Issue at risk: Technology decoupling between the US and China significantly accelerates in scale and scope.
Overall view: Strategic competition between the US and China is driving global fragmentation as both aim to boost self-reliance, reduce vulnerabilities and decouple their tech sectors.

4: Major cyberattacks
Issue at risk: Cyberattacks cause sustained disruption to critical physical and digital infrastructure.
Overall view: The pace of cyber-attacks increases as the Russia-Ukraine conflict persists. Tensions in the Gulf could also lead to increased attacks by Iran.

5: Gulf tensions
Issue at risk: Iran nuclear talks collapse, and tensions escalate, raising the risk of a regional conflict.
Overall view: The risk of military action in the region is at its highest point in a decade.

Source: The Blackrock Geopolitical Risk Indicator

It is almost like the moons are aligning for a more domestic focus.

Richard Tomlinson, Local Pensions Partnership Investments

Nevertheless, asset owners should, he notes, expect their active managers to be assessing the risks posed to their investments and whether these are being rewarded.

So how long will the spectre of a geopolitical risk supercycle hang over the global economy and the investment world? Like Lawrence Oates' walk: it could be some time.

"If you take the long view, these type of cycles are generational," Tomlinson says. This in itself has clear implications for how institutional investors deal with a geopolitical risk supercycle.

Investors therefore need to buckle down for a risk supercycle that will shape investment for decades to come.

Summing this up for investors is a quote from Sergeant Phil Esterhaus from the 80s TV show, Hill Street Blues: "Let's be careful out there."

pi

DEFINED BENEFIT: NEW PERSPECTIVES

Defined benefit (DB) pension schemes face numerous challenges on many fronts. The first is regulatory, with two big, interlinked initiatives potentially redefining the world of DB pensions.

The Department for Work and Pensions consultation on the draft Occupational Pension Schemes Regulations 2023 and The Pensions Regulator's DB Funding Code of Practice look set to change a great deal for DB pensions.

These will shift the impetus of trustees at DB pension schemes to adopt a funding and investment strategy that sets out the 'endgame' for their scheme and how they will get there – bringing with it challenges along the way. There are also other potential consequences of which DB schemes will need to be aware. This comes after DB schemes were caught up in the gilt volatility of September and October 2022. What are the lessons for DB schemes from such a tumultuous event? And how should schemes approach liability-driven investment, after it was the forefront of much that occurred?

All of this raises a big question about what the path ahead should look like for DB schemes. We sat down with BlackRock to find out.

AN INTERVIEW WITH ANDREW REID

A DEFINED BENEFIT ROADMAP

BlackRock's managing director Andrew Reid tells *Andrew Holt* about the impact of last year's gilt volatility on DB pension schemes, and the trend that could see liability-driven investing (LDI) continue to be important and evolve with regulation and schemes' journeys.

September's gilt volatility had a deep impact on many defined benefit (DB) pension schemes. How do you view the affair?

I would like to take a step back, if I may, and look at the whole of last year. Generally, the funding positions of defined benefit pension schemes improved in 2022. By far the biggest influence was the sell-off in real rates. The yield on long dated index-linked gilts has the greatest impact on the value of a pension scheme. If that yield rises, the value of a scheme's liabilities falls. And that yield climbed by around 3% per annum during 2022, which had a huge impact on liabilities. As a rule of thumb, a 1% per annum increase in yield might lead to a 15% decrease in the value of a scheme's liabilities. So it is huge.

Now, most defined benefit pension schemes have liability-driven investments (LDI). In its broadest definition, it means considering your liabilities when you invest. A narrower interpretation is achieving real yield exposure through hedging interest rates and inflation. How it typically works is that if your liabilities rise in value, you buy an equivalent asset that roughly goes up by the same amount. If your asset portfolio matches any change in the liabilities, through changes in the yields, then you would be 100% hedged.

Last year, because schemes were less than 100% hedged, liabilities fell further than assets did, so pension scheme funding positions improved, perhaps by 10% or more, on average.

The funding level is the value of assets divided by the value of liabilities with 100% classed as fully funded. Overall, the sell-off in real rates last year was a benefit for most pension schemes.

That is good context, but there were tumultuous events in September and October.

The volatility in September and October was unlike anything seen before in the index- linked gilt market. In a single day, the yield on long-dated gilts jumped more than 70 basis points, which had a huge impact on value.[1]

If, for example, the duration of these gilts is 30 years, that would have been approximately a 20% shift in the value of their liabilities within a day. We have never seen anything like that before. We had several of these big shifts, in the same direction, on consecutive days.

The largest single day movement prior to September and October, was in the order of 30 to 35 basis points.[1] This means that when pension schemes hedge through entering into swap contracts or repurchase contracts with banks, they are locking in a particular rate. If the market rate goes up, then the pension scheme has to post collateral to the bank. If the market rate goes down, the bank has to post collateral to the pension scheme.

For decades the move has mainly been down, so banks posted collateral to pension schemes. But in September and October last year, yields went up a lot and pension schemes needed to post collateral to the banks.

The way these portfolios were generally managed meant that they could stand real rates moves that were significant compared to pre-Autumn-22 market conditions. But during the height of the volatility, the collateral buffers held were equivalent perhaps to only a few days' worth of movement. The difficulty came when schemes had to find additional collateral to sell quickly. Moreover, no one knew when the increases would end. A scheme may have had enough cash or gilts to withstand a yield rise of 150 basis points, but if it was more than that, they needed to sell other assets to post them as collateral. That is what caused the difficulty. It was a liquidity issue rather than a funding issue.

Within a few days, gilt yields rose 200 basis points. Then, on 28 September, the Bank of England announced it was going to support the market through purchasing gilts up to a certain limit each day. That calmed the market and yields fell considerably. Then they went up. Then they went up again.

The Bank of England then announced that rather than just buying conventional gilts, it would buy index-linked gilts, which calmed the market and yields fell. There were changes at the top of government, calming statements were made and the market settled.

What are your takeaways from the impact on defined benefit schemes' collateral? If schemes couldn't find the cash to post, they had to take a risk or reduce their hedge. If that happens – and you only temporarily want to take it off – you likely do it when it is cheap and replace it when it is more expensive. This could cause an element of underperformance. There may also be broader impacts from selling other assets to generate collateral. Looking at the longer-term impact, thinking of LDI portfolios we expect an increase in a scheme's collateral buffer, especially as the Bank of England's policy committee had made noises in that direction. And in April, that is what happened when The Pensions Regulator released guidance for a market stress buffer of at least 250 basis points as well as a further Operational Buffer to increase resilience.[2]

There is also the issue of less leverage in pension schemes. They do not need as much as they had before due to improved funding levels. As funding levels have improved, schemes may choose to have more lower risk investments.

And another big point is governance. If you are a big scheme with a lot of resources then you have people who make sure assets are sold and cash is posted when needed. If you are not, then you need procedures to make sure those people are available if needed. They will have to spend significant amounts of time on these events, should something of the same magnitude happen again.

This is driving consolidation of one sort or another. It could be consolidation in terms of OCIO [outsourced chief investment officer]. Moreover, as an alternative, some schemes are giving LDI managers more assets to manage, so they can access these quickly and directly in times of market stress.

The outcome here could be some form of what we call a collateral waterfall

The volatility in September and October was unlike anything seen before in the index-linked gilt market.

1) BlackRock, as at 31st December 2022
2) The Pensions Regulator, 24 April 2023

Pension funds have benefited from LDI during the past two decades.

structure. This could be a LDI portfolio supported by cash and something like a short-duration corporate bond or an asset-backed security fund that has daily liquidity. It gives you a bit of return when you don't need it for collateral, but if you do, you can sell the assets to get cash quickly.
I suspect professional trustees are seeing an increase in interest also.

Is there anything around LDI that should be questioned based on the events of last year?
Pension funds have benefited from LDI during the past two decades. It enabled them to meet their dual objectives of managing their biggest risks at the same time as being able to invest in return-seeking assets that are expected to reduce their funding shortfalls.
Over the long-term, it has been a benefit, but it needs to evolve. As I mentioned, this is along the lines of more collateral, less leverage, more access to other assets and a stronger overarching governance framework, so if there are issues when action needs to be taken quickly, then that can be done.

In this new landscape, DB pension scheme trustees face many tests on many fronts. What are the priority challenges they face?
One comes at this from what we have been discussing: funding levels have improved. There are new funding and investment regulations and the code of practice. At the forefront is the ability to pay contributions to the scheme as and when needed.
We would have thought that with the changes last year it would be time for an investment strategy review for most pension schemes. Our experience is that they are doing this now – with their consultants, their internal teams and with their asset managers.
They may find their asset allocation mix has changed compared with last year. The denominator effect, whereby your LDI portfolio has grown, your liquid risk assets have shrunk, but you have proportionally quite a lot of alternatives and more illiquid assets than maybe you would want according to your asset allocation, perhaps needs to be reviewed in light of your new funding position. What we are seeing, and it is no surprise, is a big appetite for LDI and liquid fixed income. This could be used in that collateral waterfall structure. They are better funded, so need less return and fewer higher return-seeking assets, such as equities.
They can get a lot of what they need from a combination of LDI and fixed income. Government bonds, for example, in short duration, yield 3.5%. Add a bit of investment-grade credit spread on top of that and you are getting up to 5%, which is a considerably higher yield than from short dated credit around a year ago. You can now do a lot with credit that you couldn't have done in years gone by.

What endgames are DB schemes opting for?
The bulk of pension schemes are still at some stage looking for an annuity buyout, thus transferring their assets and liabilities to an insurer. They have their own resource and many of them are looking to run off their liabilities themselves. There are new entrants looking to come into the market, such as superfunds which have been around a while. So that is a possibility. The assets and liabilities would be transferred from the pension scheme to a superfund which would run them for five to seven years before transferring them to an insurer for an annuity buyout.

You can now do a lot with credit that you couldn't have done in years gone by.

The Pensions Regulator looks carefully at the covenant, that link between the pension scheme and sponsoring employer, is broken with the superfund becoming the sponsoring employer.

One thing to add is a variant of that, which is basically the same bridge to buyout methodology but not breaking the link with the sponsor. The capital-backed funding plans seek to do that. The pension scheme will still be attached to the sponsoring employer, but it will be some third party capital that will be used to support any losses in between now and buyout. There is a great deal of interest in that. We are talking to a number of providers and it could well plug a gap. You could well expect to pay a bit more as someone else is providing the risk capital, but you are considerably reducing your downside.

How is inflation and rising interest rates affecting endgames?

Those who are hedged are less concerned. All things being equal, rising rates reduce your liabilities if you are not hedged and the value of your assets go up.

On inflation, a lot of pension fund benefits are linked to it. If inflation goes up that can be a bad thing; that is why many hedge against it. However, if inflation is high then many pension schemes have a cap, so the impact can be more limited. Schemes need to think carefully about how they are impacted. And if there is something that is hard to predict and is potentially damaging, then that would point towards hedging, or substantially hedging.

Then what investment strategy options should DB schemes consider?

It is defined by the funding level and what is happening with the covenant, but more in fixed income, LDI and cashflow matching. Schemes have to consider the endgame objective in the light of the new funding code that would push schemes towards a cashflow matching approach. If you are sufficiently funded to cashflow match you will be largely using bonds (assuming you don't need an excess return from equities).

Here, it is probably worth talking about bulk annuities. There has been a maximum of £40bn worth of annuities purchased in a year, which is where we are now, and less than 3% of total pension liabilities. A lot of pension schemes are sufficiently funded to buy annuities: so is there the market capacity in insurance to take them? Are there enough people to turn the wheel to make the trades happen? As these are big trades, are there sufficient assets for insurers to invest in? So even though schemes may want to buy out, can they? Perhaps then, it is a sellers' market – with the sellers being the insurers.

And there is a value loss in pension schemes de-risking up to the point of annuity purchase, but then the insurer re-risking afterwards – what can be done to bridge that?

How influential is ESG over the investment strategy of DB schemes?

It is central to everything we do. ESG and climate risk is investment risk. Stewardship is vitally important and it doesn't apply just to equities. It can be more challenging with asset classes such as LDI to have a direct impact through portfolio management. However, we take an active role through engaging with the Treasury and DMO on their green bond framework and spending of proceeds. In addition, we engage with our counterparties through our stewardship team on a range of ESG factors.

“ESG and climate risk is an investment risk.

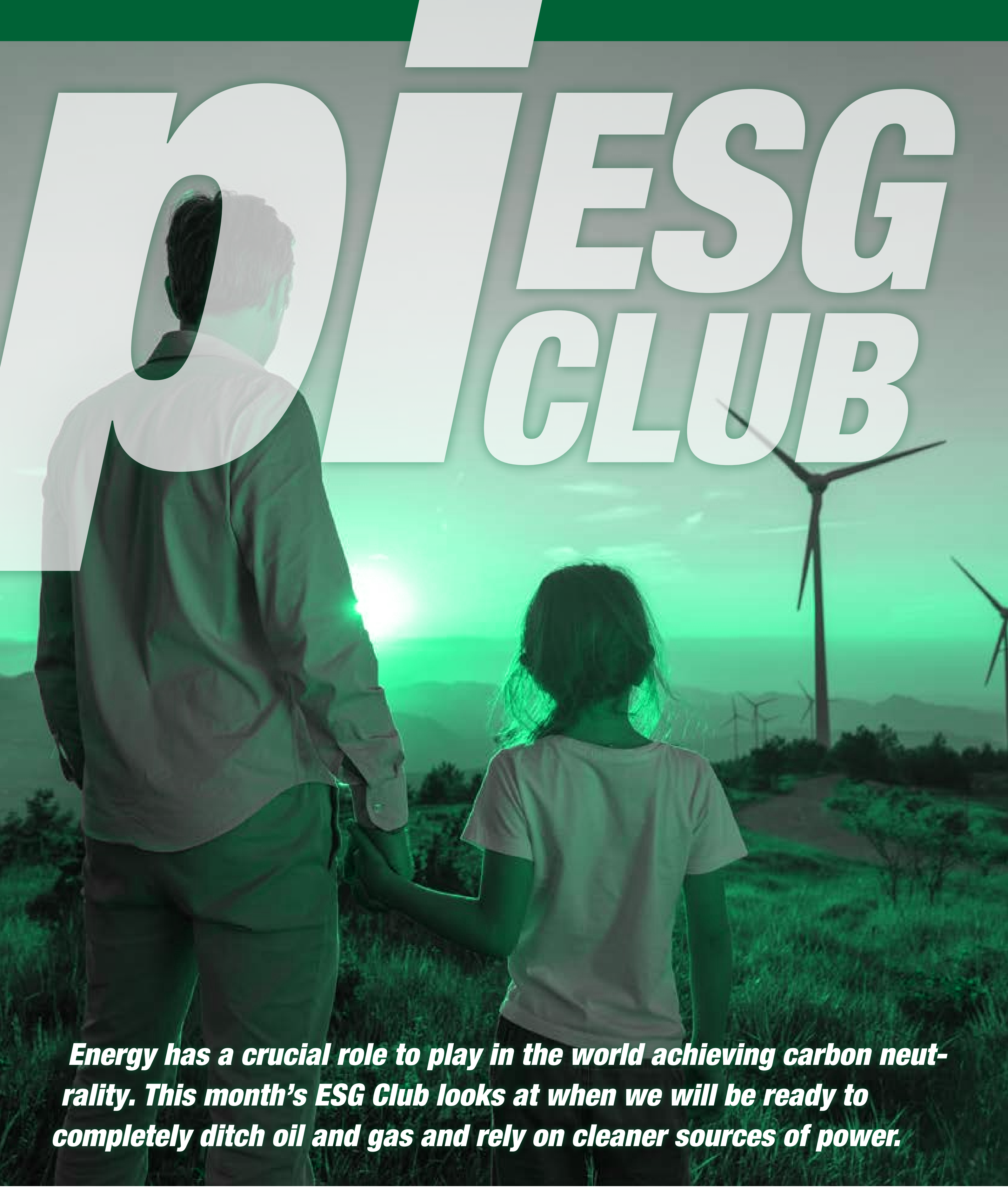
What is the path ahead for DB schemes?

There are probably a number of categories. The easiest is run off, "stay the course" if you like. Either they are big enough to do that themselves or they join forces with others via OCIO, or fiduciary management through one of the capital-backed funding arrangements.

Then there are those who have targeted a credible path to annuity buyout. They will invest in a mixture of cashflow-matching assets, corporate bonds, illiquid credits and LDI to hedge against the long-term liability risks.

For the ones going to buyout there will be a mixture of corporate bonds and LDI. Watch out for some innovation that will enable them to invest in alternative credits for a longer period, that may even transfer to an insurer. But they will need lots of liquid assets: LDI, cash and some credit when they go to buy annuities.

Then you have a tail who are in a less fortunate position. Their funding levels are not so good and they need to invest in return- seeking assets, equities and alternatives to bridge their funding gap. If there is a covenant gap, they may need to lock down what they have got and get whatever they can. So it will be interesting to see the outlook for DB pensions in the years ahead.



pi ESG CLUB

Energy has a crucial role to play in the world achieving carbon neutrality. This month's ESG Club looks at when we will be ready to completely ditch oil and gas and rely on cleaner sources of power.

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THE RETURN OF SUSTAINABILITY-LINKED BONDS AFTER A DISSAPOINTING 2022

Sustainable debt suffered a setback last year. While some point to that being a sign of things to come, others are more optimistic. *Andrew Holt* reports.

Debate surrounds the prospects of the sustainability-linked bond (SLB) market after 2022 proved to be a difficult year.

Sceptics say SLBs face growth obstacles, citing last year's decline in issuance as evidence, resulting in the asset class being at an 'inflection point', according to Dennis Sugrue, global insurance ESG lead at S&P Global Ratings.

Another point is that unlike green and social bonds, there are no restrictions on how those issuing SLBs can use the proceeds. Instead, the coupon is linked to the sustainable performance of the issuer.

This is typically done through a 'step-up' mechanism whereby the issuer pays a higher coupon if it does not achieve pre-defined targets. Such an approach 'should not be allowed or encouraged,' according to the European Banking Authority.

And like the growing field of green-related investments, allegations of greenwashing are not far away. SLBs have 'lost their mojo' due to greenwashing accusations and concerns over legal repercussions from including sustainable key performance indicators in their bond documentation, according to an assessment of the market by Barclays.

The lack of a premium on SLBs also makes them less attractive, Barclays added.

Yet despite this, Moody's said in a report that it expects about \$75bn (£60bn) worth of SLBs to be issued globally in 2023, an uptick from last year's decline, where \$70.4bn (£57bn) was raised. Context should be noted here: one in which 2022 was tough in the debt markets overall.

Jo Richardson, head of portfolio strategy at the Anthropocene Fixed Income Institute, said any criticism of SLBs is misplaced. "They improve disclosure from issues and elevate sustainability into a key part of investor dialogue. This improves regulatory disclosure around sustainable performance."

She added that such debt products could introduce real change. "SLBs have the potential to be a transformational product; uniquely suited to raising capital to transition businesses in hard-to-abate sectors," she said.

On the decline of SLBs last year, Richardson added: "Volumes of SLBs decreased in 2022, alongside volatile market conditions. Growth is recovering, alongside positive market sentiment for the complementary role of this product alongside other sustainable debt instruments."

She said that SLB issuance is more focused amongst corporate entities, often high yield or unrated. "Investor demand appears to be strong, incorporating sustainability commitments into these debt products," she added.

Bank on the SLB

Other areas of growth in the adoption of SLBs that have been cited are among banks and sovereigns, looking to embrace the asset class as they seek to reinforce their sustainability commitments.

Chile was the first sovereign to issue an SLB in March 2022, selling \$2bn (£1.6bn) worth of 20-year paper. Uruguay followed in October.

The simplicity and flexibility of SLBs could appeal to more emerging market sovereigns that may find it difficult to meet the reporting requirements for use-of-proceeds bonds, Sugrue said. A point highlighted by a World Bank survey of 28 emerging market sovereigns last year, where six said they were considering sustainability-linked bonds.

The growth of SLBs has fed across different sectors. Italian energy group Enel issued the first such debt in September 2019, agreeing to pay 15-basis points more if it missed its renewable energy target. Then rapid growth was predicted for the SLB market as the instrument would allow a broader universe of issuers to obtain sustainable financing due to the flexibility in how funds are spent.

And while this played out, with global SLB issuance growing 10-fold in 2021 to \$94.38bn (£76bn), activity tailed off in 2022 to \$70.4bn (£57bn), according to S&P Global Ratings.

In the financial space, mortgage lender Berlin Hyp became the first bank to issue an SLB in 2021. It allowed the bank to share its decarbonisation plans and progress with market participants and show its commitment to reaching its target, said Bodo Winkler-Viti, head of funding and investor relations.

Taking a holistic view

Another advantage of an SLB is that it takes a 'more holistic approach' because it relates to the whole organisation and not a single portfolio, Winkler-Viti added.

In addition, the short period of time SLBs have been around has to be considered when assessing them and their development, Richardson said. "The products have only been around for three-and-a-half years. If you look at how long it took green bonds to grow, it took longer."

Richardson concluded that SLBs should be a strong consideration for investor portfolios. "They are a powerful product. Elevating sustainability into the dialogue. All investors should be thinking about them, especially for fixed income.

"Investors should be thinking about the sustainability of their own portfolios and sustainability bonds enable you to have visibility over these plans. Sustainability bonds can act as a good hedge. They are a powerful complementary product."

INTERVIEW – JANE FIRTH

"Engagement alone will not result in real world change."

Andrew Holt discusses stewardship, driving real change, the data challenge and COP not being much cop with the head of responsible investment at pension pool Border to Coast.

How do you embed ESG and responsible investment into Border to Coast's investment process?

We are a long-term investor and it's therefore important that we take a holistic approach to understanding all the risks and opportunities a company faces when we are making investment decisions. Our portfolio managers incorporate material environmental, social and governance (ESG) issues into their investment decisions in the same way they think about valuation, management quality, competitive advantage and profitability.

This starts with the research we conduct, whether it's for listed equities, fixed income or private markets. ESG is factored into that initial process through detailed stock and issuer research and private markets due diligence.

It's also a central component of our external asset manager procurement and appointment process. We monitor managers quarterly and conduct an annual deep dive on how they include responsible investment in their process.

What is your approach to investing in innovative climate change technologies?

We recognise that more investment is needed in infrastructure and technology to facilitate the transition to a low-carbon economy. Engagement alone will not result in real world change. We are also looking for good investment opportunities.

That's why we have committed to increasing our investment in climate solutions with the support of our partner funds through their asset allocation decisions. We are facilitating this through our private markets programme, which through the infrastructure offering includes an energy transition theme.

In 2022, we also launched a dedicated Climate Opportunities offering targeting investments that will have a material positive impact on climate change and support long-term net-zero carbon emission goals.

You have an ambitious net-zero plan. How is that going?

We have always factored climate risk into our investment analysis and have continued to evolve this process. Border to Coast has worked across the investment team to understand the climate risks and opportunities in our portfolios and conduct enhanced risk assessments for the largest emitters using a range of tools and data.

We have communicated our net-zero targets to our external managers and are working with them to implement those into the portfolios they manage. Stewardship, and working with companies to have viable transition plans, is critical to reaching net zero and so is a central component of our Net Zero Implementation Plan.

The low carbon transition is already one of our four priority engagement themes and we have developed our stewardship approach to support the ambitious targets we have for financed emissions under engagement.

Our voting policy has been strengthened again on climate change with a focus on

We believe in engagement as a tool to influence change in company behaviours. As mentioned, stewardship and engaging with our investee companies is crucial for us to meet our net-zero goal. We have four priority engagement themes: low carbon transition being one, with others focused on diversity, labour, waste and water.

We have increased the size of the responsible investment team during the past year and now have a stewardship specialist supporting our approach. We also have an external engagement provider engaging on a broader range of ESG topics.

It's important that stewardship – voting and engagement – is incorporated into investment decision making and isn't something that's siloed. That's why our portfolio managers are involved in voting decisions and engagement meetings.

the oil and gas and banking sectors. We have pre-declared our voting intentions ahead of some key meetings.

As part of our net-zero goal, we have set short and medium-term emission reduction targets covering our in-scope assets.

We monitor our metrics on a quarterly basis and report annually through our climate change report. We have already made big cuts since 2019 and are confident of meeting our 2025 and 2030 targets.

What are the biggest challenges within that plan?

It's important that we look at forward-looking metrics where possible and not just focus on carbon metrics and footprinting. Carbon data can be out of date and doesn't reflect the transition plans companies have in place.

We use tools available such as the Transition Pathway Initiative tool, the Climate Action 100+ net zero company benchmark indicators along with other data metrics to assess where companies have made commitments to being net zero.

We need all sectors of the economy to make and enable the transition. Rather than excluding entire sectors we need to assess where companies have credible plans. Otherwise, there's a risk that we could end up restricting the investment universe unnecessarily and have concentrated portfolios with the associated investment risk that brings.

Data is still a challenge, especially for more esoteric asset classes. Coverage for fixed income portfolios is improving and we are engaging with external managers to improve our coverage. It is still challenging to get data for some multi-asset credit areas and private markets.

We are supporting initiatives such as the ESG Data Convergence Initiative for private markets, and the Assessing Sovereign Climate-Related Opportunities and Risks (ASCOR) project for sovereign bonds to try and correct this.

You also have a big focus on stewardship. How does that fit into your commitment to ESG?

You have alluded to it, but data is often cited as a big problem within ESG. How can this be addressed?

Data is a challenge. There is a lack of standardisation leading to quality and credibility issues. Coverage can vary significantly across different markets, especially in emerging markets, and methodologies also vary between data providers.

Arguably data is still an issue for carbon and monitoring climate risk, but this is an even bigger challenge when looking at nature-related data and future disclosures for the Taskforce on Nature-related Financial Disclosures.

Having a standardised approach is critically important, this is hopefully being addressed through having a global baseline for sustainability disclosures, which should improve the quality of disclosures and decision-useful information for investors.

Will investors using engagement to change company attitudes to ESG move the dial on climate change issues?

As long-term investors, we have chosen to use the strength of our collective voice to influence companies to drive change in the companies we invest in. We believe the most effective mechanism is through active engagement.

We do this directly and through our membership of initiatives and investor groups, such as Climate Action 100+ and the Local Authority Pension Fund Forum (LAPFF).

This is to push businesses to take real steps, whether that's reducing emissions and setting reduction targets or addressing social aspects, such as modern slavery.

We believe engagement secures lasting, positive changes that will make a real contribution to achieving the low-carbon transition the world needs. We have seen positive outcomes with companies making net-zero commitments and improving disclosures.

However, this year we have seen some companies backsliding on previous commitments, so it's important that as an investor we continue to hold those companies to account and have those challenging conversations.

We also use the power of our collective voice to engage with and influence regulators, policymakers and the wider industry to put the measures in place required to have a real-world effect.

In what circumstances do you consider divestment? And how often have you used it?

Our belief in engagement does not mean that we will hold companies that are under engagement indefinitely. We have an engagement escalation strategy, which forms part of our responsible investment policy. If companies are not responding we may need to escalate our approach.

We will do this through a number of channels including voting and filing shareholder resolutions; divestment in individual companies is an important part of this engagement toolkit. Whether a company is responding to investor engagement or not also forms part of our investment decision-making.

> **We need all sectors of the economy to make and enable the transition.**

For example, climate change issues were part of the decision to sell our position in a range of companies, such as Exxon and Korean utility KEPCO.

What did you make of the last COP? And what do you hope for from the next one?

COP27, in the vast majority of areas, failed to live up to its billing of the 'Implementation COP'. There were some positive developments including the agreement of a formal work programme on a just transition and the establishment of a loss and damage fund. However, there remains a distinct lack of agreement on how plans should be put into action.

The main issue as an investor is that slow progress means the risk of not meeting that key 1.5-degree target by 2050 increases, and so we will continue to engage as an active steward and responsible investor to manage and mitigate that risk over the long term.

Do we expect more from COP28? It is difficult to say. As responsible investors, our fiduciary duty is to ensure that we identify the risks and opportunities of climate change and act in the best interest of all our stakeholders – and the planet.

The risks are well identified. However, with regards to the opportunities, we hope for more decisive action in the area of climate finance to scale up mobilisation of private capital in low-carbon mitigation and adaptation projects, across all sectors, vital for the rapid transition to a low-carbon economy.

Our dedicated £1.35bn Climate Opportunities offering is an example of Border to Coast's commitment to facilitating increased investment in climate transition solutions. This is invested over a three-year period targeting investments that will have a positive impact on climate change and support long-term net zero carbon emission goals. It includes investments across private equity, infrastructure and private credit.

The BridgeTown initiative from COP27 – which set out to address immediate financial needs while also starting to address systemic issues requiring transformation of the financial system – was a positive start. We will be watching to see how this proposal is further developed.

Hosting the conference in another influential petro-state could be seen as problematic in formalising agreement, but it is hoped that commitment to a global stocktake of the Paris agreement may help focus minds.

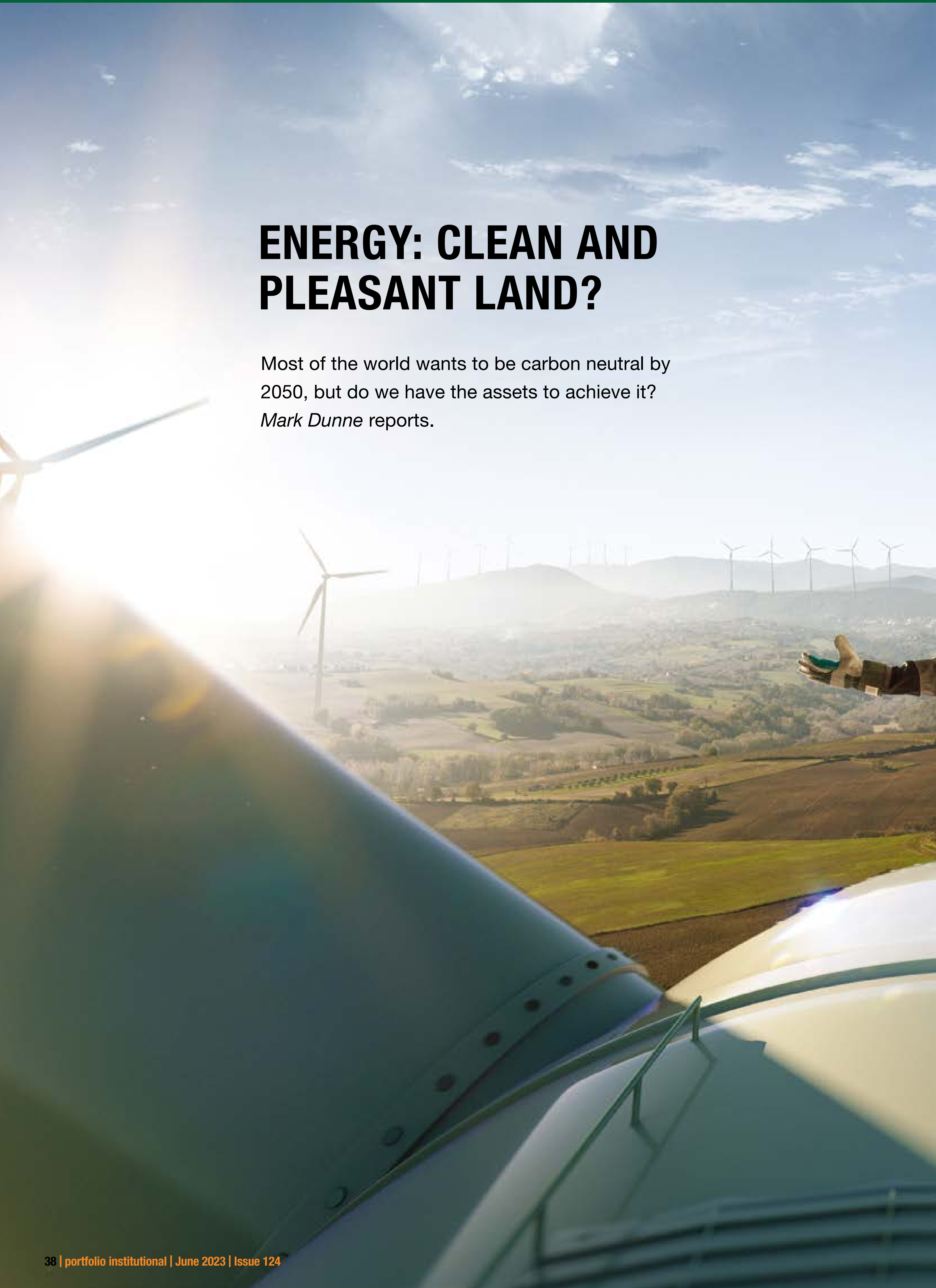
What is next for Border to Coast on ESG?

We will continue to progress our three-year responsible investment strategy, which is made up of four pillars: ESG integration, active ownership, industry engagement as well as reporting and governance.

This is our second year in the three-year strategy and was developed to ensure we can support our partner funds, who are, of course, local government pensions funds, in delivering against their stewardship responsibilities in line with regulations. As active stewards and our focus as long-term investors, we will continue to work to make a difference with the collective voice that pooling brings.

ENERGY: CLEAN AND PLEASANT LAND?

Most of the world wants to be carbon neutral by 2050, but do we have the assets to achieve it? *Mark Dunne* reports.



Britain is full of wind. For the first time the energy that lights up our homes at the flick of a switch and allows us to keep working when the battery powering our laptop runs flat has mostly been generated by wind turbines.

Indeed, this accounted for almost a third (32.4%) of Britain's electricity during the opening three months of the year, slightly ahead of gas (31.7%), power company Drax says.

It gets better. If solar, biomass and hydro are considered then the gap widens with renewable sources responsible for 42% of Britain's energy during the first quarter, compared to a third for oil and gas. The growing dominance of cleaner energy sources and the decline of carbon dioxide-emitting oil, gas and coal will be welcome news. To halt the damage to our climate that causes rising temperatures, extreme weather patterns and asthma, the government wants all of Britain's electricity to be generated from clean sources by 2035.

Although decarbonising the energy mix is moving in the right direction, eradicating fossil fuels from the system is a challenge. Oil and gas have powered our lives for around 200 years and developing the reliable alternatives needed for such structural change will take time. And that is something we are running out of. The world has set ambitious net-zero targets, with the typical deadline being 2050 – just 27 years away.

One of the biggest issues is that the favoured alternatives to burning oil and gas are not as reliable as fossil fuels. Wind farms only produce power when the wind blows and solar parks when the sun shines. "How can we change a grid from something which is very much in the past – coal, oil and gas – where lights come on at the flick of a switch, to a point where you have to organise the energy load around wind speeds and when the sun is shining. This is a challenge," says Gabrielle Kinder, an investment specialist in BNP Paribas Asset Management's environmental strategies group.

The problem is not limited to how we power our homes and businesses, but also how we move around the world.

Electricity is seen as the solution to stopping the pollution emanating from our roads. However, the concerns associated with battery-powered vehicles include cost, range and the size of the recharging infrastructure.

Then there is maintenance. A survey conducted by consumer group Which? found that electricity is the least reliable type of fuel, with such vehicles spending longer off the road when in need of repair. In response, battery-powered car maker Tesla cut the price of its vehicles twice this year to tempt buyers.

It is clear that transitioning the world from an extractive to a regenerative power base will take money…lots of it.

Craig Bethune, a senior portfolio manager on the capital appreciation team in Canada at Manulife Investment Management, believes that in the coming decades $6.9trn (£5.5trn) needs to be spent annually. "It's a big ask," he says, "but net zero is going to be a challenge for the world to achieve without aggressive spending."

Digging deeper

If electricity generated from renewable sources is at the heart of transition plans across the world, more natural resources, such as copper, need to be taken out of the ground to build the car batteries, wind turbines and solar panels that are crucial to eradicating the use of fossil fuels.

Wood Mackenzie, an energy consultant, says that to produce the copper, nickel and lithium needed to reach net zero, mining capex needs to rise from $30bn (£24.1bn) to at least $100bn (£80.5bn) a year until 2050. "So you get a sense of how difficult it is," says Diana Racanelli, a senior portfolio manager on the capital appreciation team in Canada at Manulife Investment Management.

More than 30 years of monitoring the mining industry has given Racanelli a greater understanding of the enormity of the net-zero challenge. "One of the problems with reaching these transition targets is that we don't have enough of the metals required.

"Copper is a big one because it is needed at so many levels of the transition, but there is just not enough of it," she adds.

The market is expected to be so tight, she says, that copper producers are starting to discuss the risk of possible substitutions for the commodity in certain uses. "There has to be alternatives and the world is starting to look at that."

But there is a conflict when it comes to producing more of the minerals needed, as investors have traditionally pushed for higher returns from their mining stocks or companies have reduced their exploration spent to pay down debt.

The barriers to producing more of the minerals needed are not just down to money. There are other issues. One is that it can take well over more than a decade for a newly discovered mine

The focus needs to be on emission reductions, not excluding one type of power over another.

Diana Racanelli, Manulife Investment Management to reach full capacity. Then some countries have political issues, labour shortages and extreme weather impacts while or regulation can beis tighter in different juris-dictions. “There is a wide range of issues making it difficult to mine some of these metals,” Racanelli says.

An alternative, especially for hard to decarbonise sectors, such as transport and industrial processes, is hydrogen. Policy support in this area is strong and Morningstar expects hydrogen demand to grow substantially in the coming decades.

Hydrogen can be stored in in a transportable form and produces no carbon dioxide when burned. Morningstar says that $22bn of such projects have secured funding globally, which equates to about 26 million tons of clean hydrogen capacity, roughly a third of what will be needed to meet the IEA’s 2030 net-zero targets.

Step by step

It appears unlikely that there will be one source of energy that saves the day here. Many alternatives to coal must be employed to help get us to net zero and some sources will not be on everyone’s wish list. “You can’t be a snob here. You can’t pick and choose what you think you need,” Bethune says. “The focus needs to be on emission reductions, not excluding one type of power over another. Nuclear energy, for example, is low carbon, so you need to think about that as part of the solution.”

Bethune says the world can’t wait for purely clean energy to be perfected. “We need to make all of our energy one step cleaner.

“For example, liquefied natural gas over coal is a net win for the world,” he says. “It may still be a fossil fuel but if you look at the emissions profile of the US, there has been a dramatic reduction in emissions, mainly by moving away from coal to natural gas.

“You need to think about every step,” Bethune says. “It is more about emission reduction than waiting for the perfect solution.”

Liquid natural gas emits 40% less carbon dioxide on average than coal. “Liquid natural gas is a bridging fuel, but in some ways a bridge to nowhere,” Kinder says.

“Whilst it has some interesting merits in introducing flexibility into the grid, it is expensive in requiring a unique infrastructure,” she adds. “Ships need to be specifically retrofitted to transport this gas, while ports need to be equipped to transform it back into natural gas. It is expensive to move such amounts of gas around the planet.

“In a perfect world, whilst gas will be used to provide inertia when the wind is not blowing and the sun is not shining, it probably would have been best to double down into things like storage or pumped hydro, which could basically guarantee a net-zero economy,” Kinder says.

The other path to achieving net zero could be to keep burning fossil fuels and offset the harmful emissions. However, the use of offsets to mitigate the damage caused by fossil fuels through funding green projects is controversial as there are question marks around the effectiveness of these markets. “[Offsets] are not a good justification for using coal,” Kinder says. “This could improve, but it is a difficult one.”

Finding the right alternative is not the only issue. “There are challenges putting net zero at risk which I would put higher up the concern list than the available energy sources,” Kinder says.

One is the lack of consensus on net zero. While most of the world has agreed on keeping temperature rises to 1.5-degrees by 2050, some of the countries making the biggest impact on climate change are not aiming for mid-century. India, China and Indonesia, for example, have set net-zero targets for 2060 or 2070. “They have huge propensity to change whether we can stay within safe limits or not,” Kinder says.

With India and China building more coal-fired power plants, fossil fuels remain part of the world’s energy mix. “They can be made greener, which could be something of a positive story for coal,” Kinder says. “Attaching carbon capture and utilisation technologies to coal generators could remove a lot of the negative emissions and by-products you get when coal combusts.”

The transition isn’t working

While investors are pushing companies to back cleaner sources of energy, they have to consider the social consequences of dumping oil and coal – people will lose their jobs, which could hit some communities hard. The good news is that jobs are being created from a decarbonised economy. The Climate Change Committee’s A Net Zero Workforce report found that around 250,000 jobs have been created by the shift to net zero so far.

However, 65% of ‘green’ employers surveyed by Generation UK, a non-profit that supports people facing barriers to employment, confirmed it is difficult to find staff with the right skills and experience. Green-skilling initiatives need to be scaled up if we are to avoid a bottleneck on the path to net zero and growing unemployment. These skills are needed. Bethune says the world doesn’t require less energy each year. “We want more green energy, but we still need more energy overall.

“You need to supply enough energy to transition because if you have high energy costs today, it slows down the transition in the future,” he adds.

And the transition needs to speed up if the 2050 net-zero target has any chance of being achieved. The will is there with innovations being developed all the time, such as in electric vehicles (EV). “There’s a lot on the EV horizon,” Kinder says. “Re-charging is getting faster and faster every year.”

Time will tell if the transition assets institutional investors are investing in will be enough to force the structural change the world needs. More reliable assets are needed. As although Britain is full of wind, it will take more than wind to get us there.

NAVIGATING NET ZERO TO ACHIEVE REAL-WORLD DECARBONISATION

In June 2022, Newton announced its approach to net zero. We aligned ourselves with the Science Based Targets initiative, which involves a commitment to aim for an interim target of 50% of the financed emissions from the investments we make on behalf of our clients being covered by credible transition plans by 2030 with 100% covered by 2040.

It is not credible to decarbonise portfolios simply by cutting out certain sectors; that is not necessarily going to translate into decarbonising the real world, which is ultimately what we want to achieve. In practice, the path of real-world decarbonisation looks different depending on the portfolio.

In some of our sustainable strategies, for example, we look for companies that are either supplying solutions to climate-change challenges or are aligning themselves to a net-zero pathway. Infrastructure-related strategies might contain net-zero targets that are perfectly achievable for some companies, but for investments in utilities it can be more difficult as they have the transition in front of them, although that may be where a lot of the value creation will lie.

We believe that there are significant opportunities to invest in companies or lend to entities that are going to enable this transition. Members of our investment team have undertaken a mapping exercise to look at the emissions that are being produced across all sectors.

We have examined the solutions that can address each layer of those emissions, as well as the marginal cost and the viability of each step of CO_2 mitigation. This gives us a structure to know exactly what to look for, which ideas to pursue, and where we should focus our fundamental analysis.

Our multi-dimensional research platform underpins this process, and brings together colleagues from across the business, including the responsible investment and data teams, as well as our fundamental analysts and portfolio managers.

Our mapping exercise has highlighted that the backbone infrastructure that our economy runs on is going to require an energy-focused and material-intensive overhaul. The framework helps us to look right across the value chain, for example, identifying copper and lithium as key commodities, finding mining businesses to invest in, and investigating supply-chain companies feeding into mining operations, such as specialist underground mining equipment.

We also explore where these materials, such as copper and lithium, are being used and applied, for example, in solar-panel batteries and wind turbines, and can think about what the supply chains and component parts for those products look like.

In addition, we can look at who is ultimately using these products, including the developers looking for the sites and doing the construction, along with the companies operating the facilities.

Rolling out renewables

Before the Covid-19 pandemic hit, there was already a progressive renewable energy agenda being pushed out in Europe. During the pandemic, policymakers were trying to pull the agenda forward to get the economy going again, but, with the energy crisis taking hold, energy independence has become more important for many.

The main limiting factor on building renewables is not supply of solar panels, or labour shortages, but regulation. In areas where the regulator is accelerating the permitting process, the rollout of renewables is going to be faster.

When the conflict between Russia and Ukraine broke out, the European Union wasted no time in fully accelerating the permitting process. Understanding the direction of travel for regulation is therefore likely to be critical in order to determine whether there will be a faster push towards renewables. It has been suggested that the best cure for high energy prices is high energy prices, and we are now starting to see that the current crisis is accelerating the growth of renewables.

Engagement

It is important to be actively engaged with companies that have credible transition plans in place, and to understand their net-zero ambitions. This enables us to assess how realistic their goals are and to track the signposts along the way.

When we are engaging, we are on the same side of the table as these businesses. If the company is taking the right action that is going to improve its path towards net zero, that may also create a good deal of shareholder value. We want these companies to do the right thing for the right reasons, and ultimately we believe this should result in good outcomes not only for the company itself, but for the world and for our clients too.

ESG CLUB CONFERENCE 2023: DRIVING CHANGE IN CHALLENGING TIMES

After the success of *portfolio institutional's* first in-person ESG conference last year, we are returning to The Shard in September to dissect another set of sustainability issues.

Climate change, biodiversity loss, inequality and corporate governance are some of the biggest issues of our time.

Working to create an ecosystem that can support life on Earth, while boosting societal equality and encouraging organisations to behave appropriately are the goals of a growing number of citizens across our planet.

Such is the importance in phasing out oil and gas from our energy system, or providing access to healthcare, or how well employees are treated and local communities are respected that governments have adopted targets in some of these areas to drive change.

But there is a problem, and institutional investors are right in the middle of it. How can pension schemes, charities and insurers make sure the companies in their portfolios have practices that are kind to the environment and respect human rights in their supply chains?

It is a lot harder than it sounds to spot if a company is as 'green' as it claims, remember Volkswagen's pollution test scandal? Then there is the issue of is it treating its employees fairly. Boohoo is an example of a company worth billions of pounds where the workers making its clothing were being paid less than minimum wage to work in unsafe conditions.

pi ESG CLUB CONFERENCE

The Shangri-La Hotel, The Shard
13 September 2023
09:00 – 15:30

To strip away the complexity and to highlight best practice on sustainability, *portfolio institutional* formed an ESG Club where assets owners, those investing on their behalf and consultants discuss issues such as ensuring access to fresh water, how to sustainably dispose of waste, are we winning the race to net zero and how can we grow enough food without damaging the ecosystem.

ESG is a broad church. With an abundance of topics within the E, the S and the G, we decided to bring our ESG Club directly to institutional investors. More than 100 people attended our first in-person event last year and with more questions on sustainability being asked as each year goes by, we are returning for our second ESG Club Conference in September at the Shangri-La Hotel in the Shard.

This year representatives of The Pensions Regulator, Scottish Widows, WWF-UK, ShareAction, the PLSA, MSCI, Guy's and St Thomas' Foundation and the Church Commissioners for England will be discussing topics such as transition assets, biodiversity, ESG data and making a social impact.

So don't miss this chance to engage with institutional investors on the big sustainability issues. We hope to see you there.

TO REGISTER TO ATTEND, PLEASE CONTACT:

Mary – m.brocklebank@portfolio-institutional.co.uk

Silvia – s.silvestri@portfolio-institutional.co.uk

Or visit: portfolio-institutional.co.uk/esg-club-conference-2023/

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PRIVATE EQUITY: RISE AND FALL?

Has private equity peaked as we head into a new investment environment? *Fiona Nicolson* delves deep into the market to find out.

Private equity "blew the doors off" in 2021, says consultancy Bain & Co when summing up what was a record-breaking year for the asset class. But the landscape has since shifted and the backdrop has changed.

Following the "stimulus-fuelled market frenzy of 2021", last year was a turbulent year for risk assets, says Preqin in its 2023 global report on private equity. The investment data specialist noted that the global private equity market is now in an adjustment period and anticipated significantly weaker levels of activity this year in terms of deal-flow, as well as in performance and fund-raising.

Also, while its 2023 alternative assets report acknowledged the strong returns that private equity has delivered to investors over the long term, Preqin said it expects performance to dip this year.

The surge in activity has ebbed, as major new challenges have made an entrance, while others in the background have moved to centre stage.

The challenges for the market have arrived thick and fast during the past few years. These include geopolitical tension emanating from the war in Ukraine and China's focus on Taiwan, along with burgeoning inflation, rocketing interest rates and market volatility.

And that's not all. According to Bain & Co's global private equity report for 2023, a host of other macro-economic trends have been having an impact too, such as natural resource shortages, global food pricing and supply disruption, recession risks and technological disruption.

Seen it all before

However, despite the tumultuous times, Bain's outlook is upbeat. "Despite the recent drop-off in deal, exit and fund-raising activity, 2022 was still the second-best year in history, and the underlying fundamentals remain sound," the company reports.

While it points out the challenges faced by private equity, it also highlights the robustness of the sector: "Unlike the 2007–08 period, when the global banking system nearly collapsed, nothing appears fundamentally broken this time around. While all signs point to a shift in the economic tide, the magnitude will be nothing the private equity industry hasn't dealt with before."

Putting the macro-economic worries to one side, the year has started on an encouraging note. In its end of first quarter report on private equity, Preqin pointed out that there's an ample amount of dry powder in the market globally – a healthy $1.54trn (£1.24trn). Total dry powder will climb to $1.92trn (£1.54trn) by 2027, it estimates in its 2023 global private equity report.

This positive outlook on private equity is evidenced in the plans of institutional investors. According to a global report on private markets published by State Street in May, nearly two-thirds (62.5%) of major institutional investors surveyed plan to make private equity their largest allocation in the next few years. The research also revealed that despite the tough macro environment, private equity is still the most popular private market.

One of the people behind the research said they surveyed more than 500 institutional investors about challenges and opportunities in investing in private markets and found strong support for ongoing investment in this asset class.

"In fact, 68% of respondents indicated that they would continue to invest over time and only 25% of respondents indicated that they would allocate less over time."

Family offices are putting their faith in private equity too. Goldman Sachs' 2023 family office investment insight report, also published in May, revealed that family offices are planning to increase their allocations to private equity. Its research, which surveyed family offices that most resemble institutions (more than 70% of respondents had a net worth of at least $1bn) found that nearly half (41%) plan to do so in the next 12 months.

The researchers said the ongoing focus on private equity was "unsurprising" and attributed it to the ability of the asset class to access innovative companies earlier in their lifecycle than in public markets, as well as to its history of outperformance.

Reflecting on the reasons for the continuing popularity of private equity, despite the challenging backdrop, Martin Dietz, head of diversified strategies at LGIM, says there are clearly some positives about the asset class in general. "A lot of private equity is about buyouts and that, in principle, is about looking at relatively stable smaller companies. We see this type of company as one that tends to do quite well over the long term."

Advantages and rewards

Private equity has a wide range of plus points, says John Euers, co-head of M&G Alternatives. "Most notably its track record of delivering strong, absolute return across cycles, over the past decade, resulting in three, five and 10-year pooled private-equity buyout returns of 20.9%, 18.3% and 17%, respectively, according to data and analytics specialist Burgiss.

"With private-equity fund valuations typically taking place on a quarterly basis, these funds are often insulated from the mark-to-market swings that take place in other asset classes and over time, have demonstrated lower volatility than public equity markets," Euers says. "In addition to this, investors are often attracted to the diversification offered by private equity."

Euers also explains how investors' perceptions of high risk can be addressed: "While private equity is an asset class that is maturing, some investors may perceive it to be a high-risk strategy through the belief that they will be investing in early-stage ventures that feature binary outcomes."

This, he says, can be overcome by carefully selecting funds with a track record and through careful due diligence on their strategy.

As an example, Euers notes M&G's portfolio consists of more than 3,000 underlying companies, so benefits from a high level of diversification. "No one deal will determine the overall performance of the portfolio," he says.

Another benefit of investing through a broad portfolio of private equity funds is vintage year diversification, Euers says. "This means that our managers are buying and selling investments at different times, so we are not overly weighted to a particular point in the cycle."

Looking at the opportunities, rewards and risks for institutional investors of allocating to private equity – and more broadly, private markets, Peter Vincent, regional head of client investment solutions for EMEA at Franklin Templeton Investments says. "Private markets provide an expanded universe of investment opportunities as public markets continue to shrink and become more concentrated.

"They have matured such that many companies can stay private for longer, reducing the ability for public-market investors to access the full breadth of companies powering the global economy."

Vincent adds that private markets offer the potential for an illiquidity premium and higher manager alpha. "But this must be weighed against liquidity risk, manager dispersion and fees," he says.

New entrants

It's not just institutional investors, asset managers and family offices who see the potential of private equity. In May 2022, government-founded workplace-pension scheme Nest launched a private equity mandate, appointing Schroders Capital to manage it. This was followed by awarding a second mandate to HarbourVest in July.

Nest said it anticipated having around £1.5bn deployed in private equity by early 2025, with a longer-term target to have

> **Investors are often attracted to the diversification offered by private equity.**
>
> John Euers, M&G Alternatives

around 5% of the portfolio in private equity. A year later, in May 2023, Nest confirms these estimates remain the same.

As an update on progress, Jess Menelon, investment policy analyst at Nest, says: "We're happy with the deals our fund managers HarbourVest and Schroders have found for us so far.

"Deployment is going well with £460m, around 1.5% of our total portfolio, already invested as at mid-April, and we are continuing to build our exposure to the asset class in line with our objectives."

For any institutional investor keen to introduce private equity to their allocation plans for the first time, there are significant considerations to be aware of, as one private assets analyst points out: "Private equity investing is typically characterised by negative returns as the funds incur management fees, transaction costs and other expenses while waiting for the invested capital to generate returns.

"Institutional investors allocating money to private equity for the first time should diversify their investments with other private investments that are potentially quicker to gain value and to distribute money back, such as secondary investments and private-credit strategies."

"At the extreme, we should expect some franchises to ultimately fail.

John Euers, M&G Alternatives

Under the surface

Despite the optimism about private equity, there are some significant lingering niggles in the market. State Street's global research on private markets reported that investors remain somewhat jittery about the deal-making environment.

More than half (51%) of respondents believe that private-equity valuations have not yet adjusted to new market conditions. Although private equity is not alone when it comes to accurate valuations – it is something rearing its head among many asset classes and sectors.

A potentially more worrying trend is that just under a third (32%) also expressed concerns about a private equity bubble risk due to falling revenues and profits of companies going to IPO. That said, this has been an issue hanging over private equity for some time. The question is, as investors fear, whether now is the time for the private equity bubble to burst.

Reflecting on the current big issues for institutional investors around allocating to private equity, M&G's Euers says: "Macro uncertainty, higher interest rates and reduced debt availability have resulted in lower deal volumes, and therefore lower liquidity, which further compounds overallocation issues."

He says several limited partners are slowing or stopping their commitments to new funds. And in some instances, they are being forced to sell private equity portfolios at discounts to generate liquidity and rebalance their portfolios. "The upshot is that many institutions are being highly selective when it comes to backing the current vintage of managers, many focusing on a smaller number of relationships," Euers adds.

This is having an impact in the market itself. "As such, we are seeing a bifurcation in the market where some managers are deemed to have successful fundraising campaigns (six to 12 months) at or above their target fund sizes whereas others are seeing a prolonged fundraising period, often needing to revise their fund targets to a lower level," Euers says.

"At the extreme, we should expect some franchises to ultimately fail," he adds. "This is not necessarily a bad thing, more an evolution of an asset class that should no longer be deemed an 'alternative'."

Vincent also highlights challenges that institutional investors are having to get to grips with. "Institutional investors are grappling with macro-economic uncertainty, 'denominator effect' issues, slowing distributions and reduced price discovery in private markets.

"All these issues are contributing to a slower fundraising environment and a preference for established manager relationships."

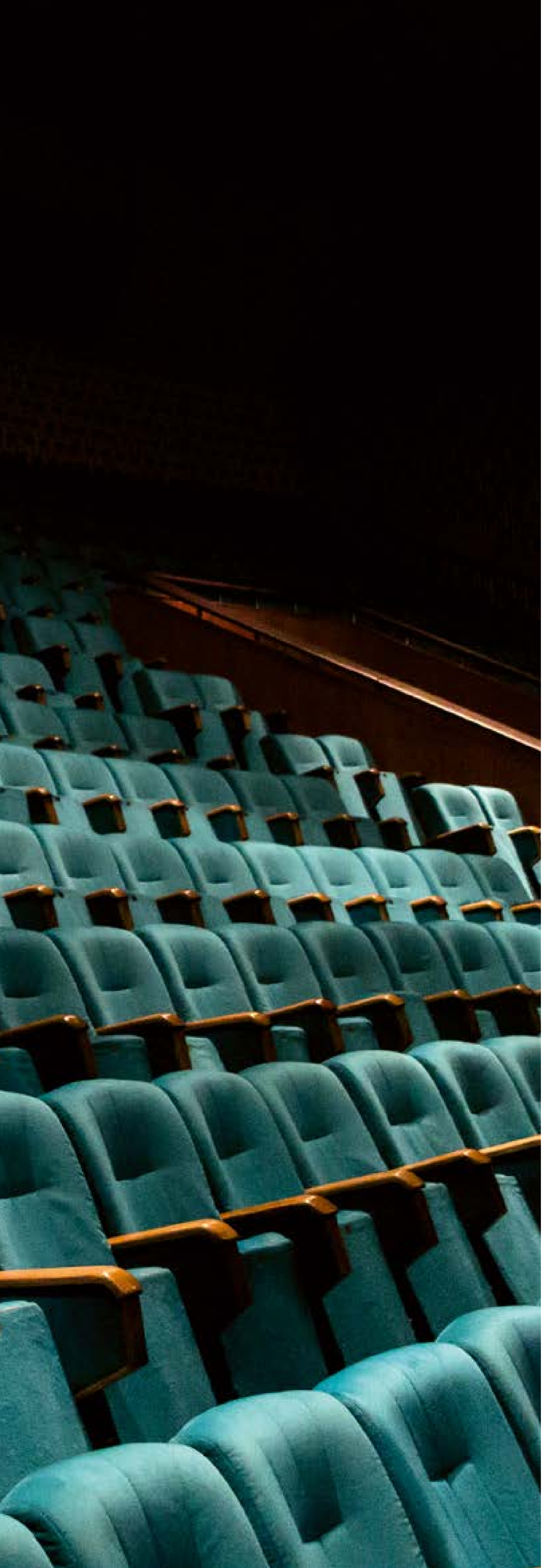
And LGIM's Dietz fires a warning on the outlook for the rest of 2023: "We're worried about economic conditions right now simply because rates have been hiked quickly in all the main markets – in the US, the UK and Europe – and we're seeing the cracks showing up in the real economy.

"Central banks might try to control inflation as a priority in this cycle and risk a little bit of a recession or some sort of an economic slowdown at least – and that is potentially negative for everything that is risky, including private equity."

If such a worst case scenario plays out, then private equity could switch from blowing the doors off, to finding itself part of a market implosion.

CDC: WHAT'S NEXT?

The so-called 'third way' of saving for retirement allows members to share the risk by pooling their savings. Following a lacklustre start, *Gill Wadsworth* puts CDC under the microscope.



It does not take long to read The Pension Regulator's (TPR) list of authorised collective defined contribution (CDC) schemes in the UK, since it comprises just one name.

The Royal Mail Collective Pension Plan (RMCPP) received authorisation on 13 April 2023, which the Minister for Pensions, Laura Trott, declared: "a landmark moment [which] is just the beginning".

But the Department for Work and Pensions' (DWP) enthusiasm is not wholly shared by the UK pension industry with many questioning whether there is widespread employer appetite for CDC.

Single and connected employers have been allowed to set up a CDC since last August, but the lack of schemes on TPR's authorised CDC list suggests a lack of interest.

Part of the slow progress lies in the sheer volume of work involved in setting up a single employer CDC scheme. It took years to get the RMCPP authorised, and the Communication Workers Union, who represented members in the switch, says there are still "some further areas that need resolving before the plan is launched and we continue to work with Royal Mail Group in our engagement with the government to ensure this happens as soon as possible".

Muted appetite

Steven Cameron, public affairs director at Aegon, says CDC may be the preserve of employers with the largest workforces, and more than likely those that are looking for an alternative to defined benefit (DB) provision.

"I suspect that unless you're a very, very large employer it's unlikely that you would want to go down the CDC path," he adds. "They would probably offer a DB scheme, and there aren't many of those left in the private sector, so the demand [for CDC] is limited."

This view is shared by Clare Altman, managing director of individual retirement at Standard Life, part of Phoenix Group, who says employers are concerned about CDC's complexity and how to manage employees' expectations that the schemes provide guaranteed income.

"We are aware that many employers do not see CDC as something they want to engage in for understandable reasons. They have spent time and effort in ensuring auto-enrolment compliance and save for the most paternalistic of employers, there is no up-side to them of CDC."

Cameron adds that he has seen no evidence of public sector DB schemes considering a move to CDC either. "I'm not aware of that being something that is being discussed," he says.

Chintan Gandhi, partner and head of CDC at Aon, agrees there are thresholds that determine the viability of CDC.

"CDC needs to be well scaled because it involves risk-sharing, and that means having several thousands of employees or members, or several millions, and in some cases, billions of pounds in assets under management."

But he argues that the appeal of collective arrangements extends beyond employers solely offering DB. Gandhi says CDC offers benefits which he calls "the three Es": efficiency, employee value proposition and ESG.

"Efficiency comes from the better bang for your buck CDC offers," he adds. "Our research shows that on average savers can achieve a 30% higher income using CDC compared to an annuity. CDC also improves the employee value proposition because there is a greater chance [than with DC] of being able to retire with an income for life, so it helps with recruitment and retention.

"Finally, when pooling contributions and investment returns together you can take a longer time horizon, and increase the opportunity set to invest in a more sustainable and responsible way."

All this, Gandhi says, makes CDC an attractive proposition, and there is evidence employers are considering risk-sharing options. "Results from an Aon poll reveal that 10% of employers are already pursuing CDC with a further 14% considering collective arrangements as part of their next benefits review," Gandhi says.

Expanding opportunities

Yet given the size constraints of setting up CDC, the government believes the opportunity to offer the schemes needs to be extended to multi-employer arrangements and master trusts.

In March a DWP consultation closed, which had invited the industry to comment on how a CDC framework could be adapted to allow more employers of all sizes to offer CDC schemes, and to allow more flexibility in design.

Echoing pensions minister Trott's excitement following the authorisation of RMCPP back in April, the DWP tells *portfolio institutional*: "We have seen the positive effect of these schemes in other countries and our plans to extend our CDC framework will enable more pension savers to achieve the retirements they want."

However, the DWP continues to consider responses and says it will respond in due course.

Again, as with the viability of CDC for single employer schemes, there is some scepticism that appetite exists for collective saving within a multi-employer or master trust framework.

In its response to the consultation, the National Employment Savings Trust (Nest), which is the UK's largest master trust and acts as the default arrangement for employers under auto-enrolment, said: "We haven't seen any evidence of an appetite among employers to deliver CDC so far", although it added that "employers are thinking about, and interested in, how to help their employees have a smoother path into retirement".

> **Is it fair to pool investment and mortality risk given the variation in the membership?**
>
> Steven Cameron, Aegon

The story is similar at Now Pensions where Stefan Lundbergh, head of DC platform, says: "I don't need to hire bouncers to keep the entrance clear for people who want to come in and talk to us about CDC.

"CDC is an acquired taste; I don't think it's going to be mainstream," he adds. "Maybe if it had been an alternative to DB 20 years ago, but it's a bit late now. There is already a solution that works with traditional master trusts, so why move to something else?"

The challenge in the way of wider take up, says Aegon's Cameron, is ensuring equity and fairness within a multi-employer CDC arrangement since there will be considerable differences in expected longevity across the membership that need to be reconciled.

"Different employers participating in CDC will pay different contributions, and the demographics of the workforce will be different, as will mortality experiences. Is it fair to pool investment and mortality risk given the variation in the membership?"

Cameron adds: "The actuarial discipline required will be far greater [than with conventional pension schemes] because of the need to ensure equity and fairness across the members."

However, according to a straw poll conducted by Willis Towers Watson (WTW) at a pension conference held in November last year, employers expressed interest in accessing CDC through master trusts.

More than nine out of 10 (93%) attendees thought that CDC decumulation would be of interest to retirees, and four-fifths (79%) wanted to facilitate it for their members. Of that 79%, nearly three-quarters (72%) say they would want to do so through a master trust.

Simon Eagle, senior director and head of WTW's CDC pension team, says: "What I take from those results is that employers expect CDC to become available through master trusts, and I expect the industry to respond to that by servicing the market."

Standard Life's Altman also envisages CDC as part of the master trust offering, noting that there are "considerable advantages for individuals and its right that the government explores how scale could be achieved and risks could be managed.

"If we can find a way of over-coming these challenges in ways that have wide-spread support then I can see CDC taking a bigger role in the UK pensions landscape, although those are not inconsiderable issues to overcome," she says.

Brand new solution

Where there is more consensus on the possible benefits of introducing CDC to the UK market is in decumulation-only arrangements, and which form a key part of the DWP's consultation.

The DWP says decumulation-only CDC "could provide those approaching retirement with an income product that allows them to share investment and longevity risk. In addition, a CDC decumulation fund has the potential to provide, on average, better returns than the traditional options of annuities or drawdown".

This is because their longer-term investment horizons mean they will be able to invest more in higher return seeking assets for longer. This, the DWP argues, means members can be confident that they have a fully managed investment fund, providing them with an income for life although the annual benefit level is not guaranteed.

I don't need to hire bouncers to keep the entrance clear for people who want to come in and talk to us about CDC.

Stefan Lundbergh, Now Pensions

Cameron says decumulation-only CDC "is definitely worth exploring" since, to a degree, it combines the flexibility of drawdown with the security of an annuity.

"An annuity gives you a guaranteed income for life but no flexibility, drawdown gives you huge flexibility but no guarantees that you won't run out of money. CDC is somewhere in between; you will be sure to get something for the rest of your life, but there's no certainty on the amount you receive."

Eagle agrees, adding: "There is lots of research that people want an income for life in retirement, but relatively few buy an annuity because they haven't been good value. Decumulation-only CDC would be a new option that could fill the gap."

Further, decumulation-only CDC can be combined with taking tax-free cash and keeping some of the pot invested in flexible drawdown.

"Thinking has moved on in favour of a more blended approach that allows people to achieve the best of an annuity and drawdown," Altman says. "We expect to see significant innovation and product development over the next couple of years, and welcome CDC being part of the pensions saving toolkit."

Levelling the playing field

The government's central motivation for considering expanding CDC is to bring the DC member experience closer to that enjoyed by DB members. However, simply offering risk-sharing among members will not achieve parity alone.

"The only thing that can level the outcomes between DB and DC is contributions," Lundbergh says. "If you don't pay the same amount [as DB] you're not going to get the same outcome, whether it's from CDC or traditional DC."

Yet since CDC schemes can be a higher-risk investment strategy which, in theory can provide a significantly higher pension for the same level of cost as a DB arrangement, and significantly more income than buying an annuity.

Looking at the RMCPP, WTW calculated the expected pension provided would typically be 40% higher than a DB environment and 70% higher than with a DC-insured annuity.

"So while CDC can't level the playing field between DB and DC overall, it has the potential to improve member outcomes in general," Eagle says.

Collective DC offers a genuine third way in UK pension savings. It has the flexibility of DC with some of the certainty of DB, but whether there is great demand for such an alternative is unclear.

Certainly, if CDC advocates want to see the arrangements get off the ground in any meaningful way, their focus will have to be on communicating its benefits to employers and their workforces.

As Altman concludes: "Getting communication right is front and centre to making this work."

THE FINAL COUNTDOWN

€37.1bn

The estimated net inflows into mutual funds and ETFs in Europe during the first quarter on the back of a positive economic outlook and a possible end to the interest rate hiking cycle by central banks.

Source: Refinitiv Lipper

6.8%

The forecast annual return from European real estate between 2023 and 2027, up from 4% a year ago thanks to improved rental growth.

Source: AEW

$77.2trn

The estimate global sovereign debt pile by 2025, up by a sixth since the end of 2022.

Source: Janus Henderson

£19.3bn

The increase in the aggregate surplus among defined benefit schemes during April to £378.6bn.

Source: Broadstone

43%

The level of British pension schemes targeting buyout, up from around 35% a year ago.

Source: Janus Henderson

$9.8bn

The estimated investment in emerging market securities during April.

Source: Institute of Institutional Finance

2.5 million

The demand for lithium is expected to treble by 2030 to 2.5 million metric tons from electric vehicle makers.

Source: Morningstar

$1.92trn

The expected level of dry powder in the private equity industry by 2027, up from $1.54trn today.

Source: Preqin

0.4%

The expected growth of the UK economy in 2023 driven by demand and lower energy prices. This is an improvement on the previous forecast a month earlier which predicted a 0.3% contraction.

Source: IMF

Quote of the Month

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Stefan Lundbergh, Now Pensions

THE MEMBER BACKING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

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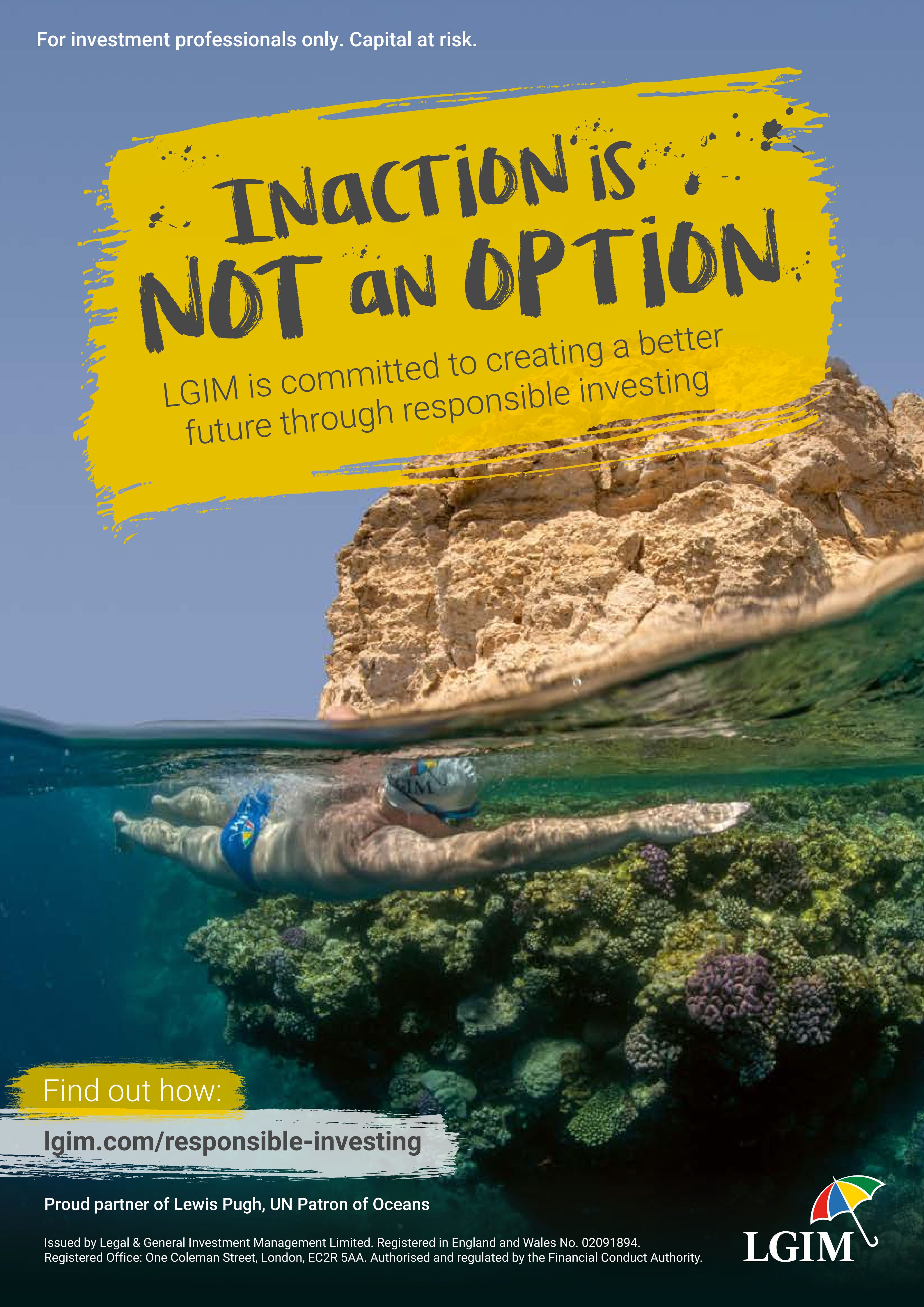
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