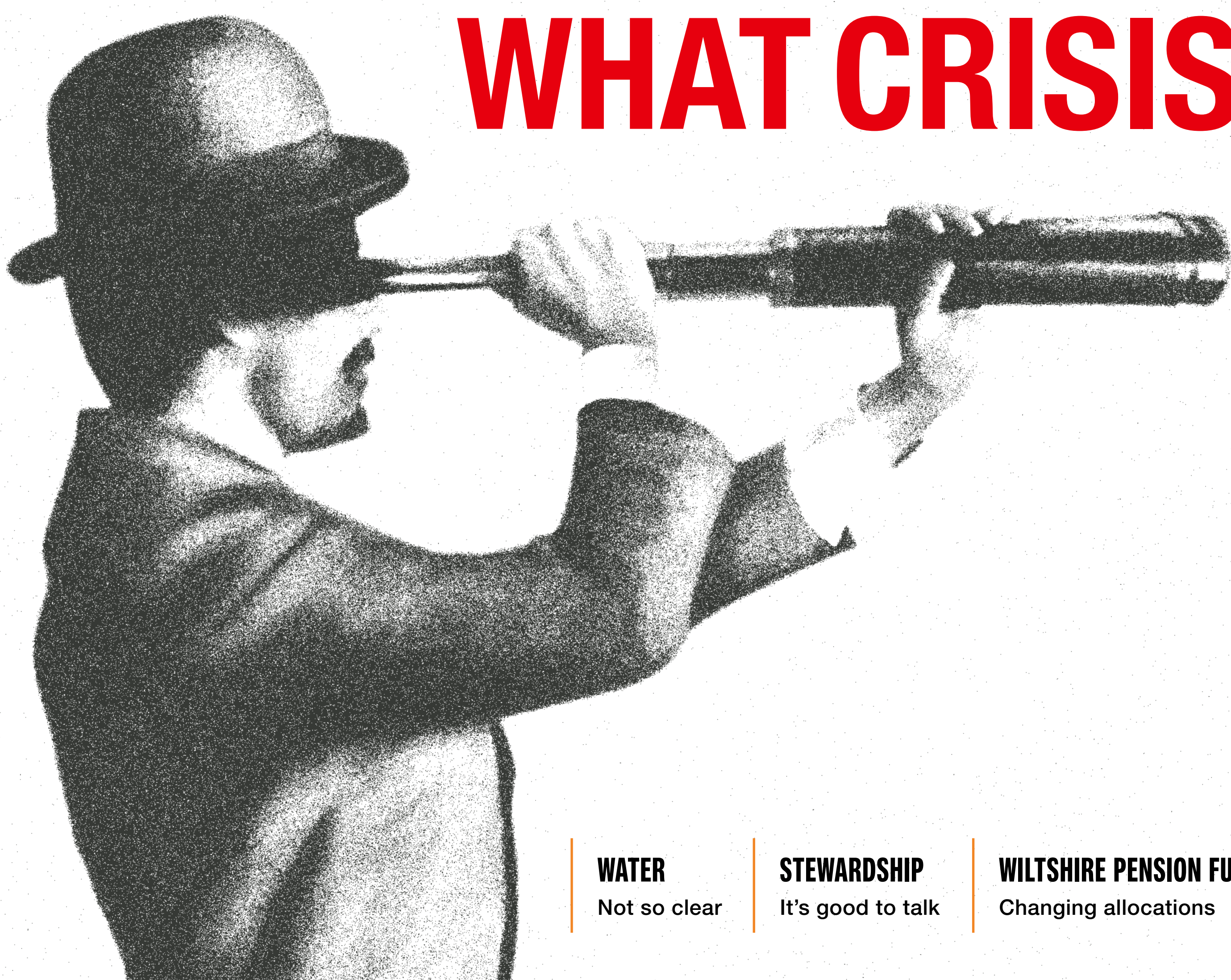
PORTFOLIO INSTITUTIONAL JULY–AUGUST 2023

EM DEBT: CRISIS? WHAT CRISIS?



WATER
Not so clear

STEWARDSHIP
It's good to talk

WILTSHIRE PENSION FUND
Changing allocations

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EM DEBT: CRISIS? WHAT CRISIS?

We are lending more money to emerging market governments and corporates than ever before. And why not? The developing world is the engine room of the global economy, generating more than half of its growth, while the United States and parts of Europe suffer from low growth and high inflation.

Yet the IMF claims the level of developing countries in or near debt distress is rising. Our cover story this month looks at whether investors should be worried or not (p.16).

Yet seasoned value investors see volatility as their friend. It creates value allowing them to attack the names on their watchlists at deep discounts. After years of relative calm, Covid, rising interest rates and inflation have brought volatility back, but where should bargain hunters look for undervalued assets? We take a look from page 20.

On the subject of watchlists, it would be understandable if many defined contribution (DC) pension schemes are looking at private market assets.

The investment case for illiquid assets is strong and so DC schemes and master trusts are looking to put some of the contributions they receive from their members into such assets. There has been reform to help such schemes invest in illiquid assets, but barriers remain. We take a look from page 46.

Private market assets, of course, are not just for DC. Many defined benefit schemes are exposed, such as the Wiltshire Pension Fund which three years ago altered its strategy to start accommodating more private equity, private credit and infrastructure. Find out why from page 12.

On a more practical level, we don't drink the water in our oceans. Nor do we consume it directly from rivers and lakes. Yet the plastics, raw sewage, agricultural waste and oil that pours into the world's waterways each day are impacting our health. Indeed, the seas purify our air, removes carbon from our atmosphere and influences our weather patterns. This is why to build a sustainable world we need to protect not only our sources of freshwater, but also the undrinkable liquid that covers 70% of our planet. Read how from page 30.

This month's roundtable discussion focuses on the changing nature of stewardship. *portfolio institutional* sat down with asset owners, those they trust to manage their assets, their advisers and campaigners to debate what best practice looks like.

Finally, the scientific director of the EDHEC-Risk Climate Impact Institute gives his expert view of what more institutional investors need to do to fight climate change.

We hope you enjoy the issue.

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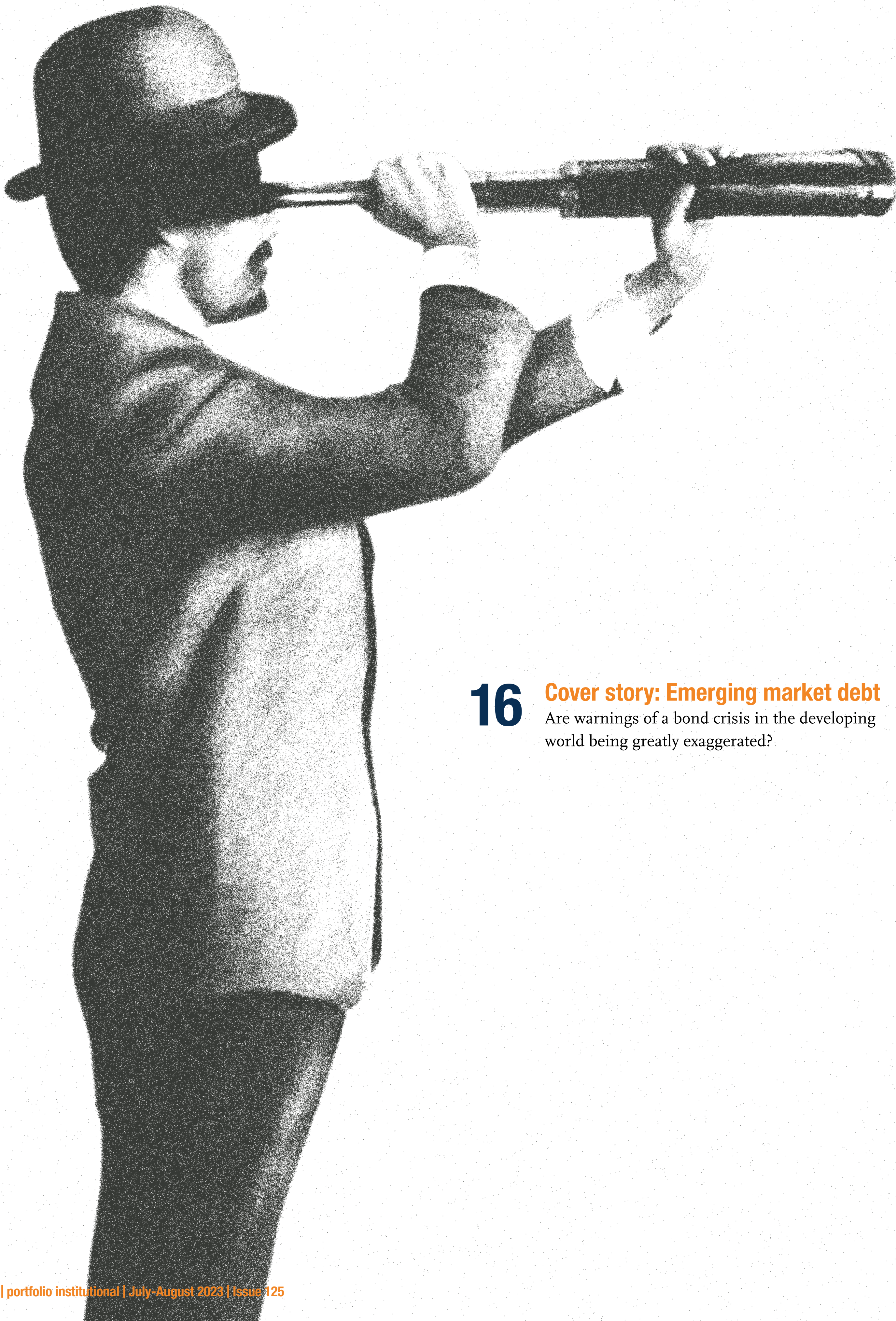

COULD PENSION FUNDS BOOST BRITAIN?

With schemes being encouraged to invest in UK plc, *Andrew Holt* assesses the level of interest.

Pensions funds supporting the UK's economic growth agenda has become a big issue, driven by government ministers wanting to tempt greater private investment in the UK, through infrastructure, private equity and tech start-ups.

It was a much-debated topic at the PLSA's investment conference in Edinburgh with the heads of investment at four major schemes at the centre of the discussions.

Liz Fernando, Nest's chief investment officer, highlighted how investors need more certainty in the UK outlook. "The one thing investors don't like is uncertainty," she said. "So having visibility on the regulatory regime, the returns regime and ideally inflation as well, as that comes into your forecasting horizons. The more visibility and certainty you can get, the easier you can commit capital."

Tony Broccardo, head of investment at the Barclays Pension Fund, added that there is an issue of incentivising investors. "It feels we are at just the beginning of the debate. There is the question about how you incentivise asset allocation and where that allocation goes to have a huge impact."

But he added his fund is already British focused. "Our liabilities are British. Like most investors we own retail parks, property, shopping centers, etc. We have quite a few government bonds," Broccardo said.

Not all the same

Wyn Francis, chief investment officer at the BT Pension Scheme, made the point that pension funds are a diverse bunch. "Not all pension funds are the same. We are all working with different objectives."

Concerning the UK economic growth emphasis on investment, he added: "There is a focus [within the debate] on the equity exposure of pension funds. The analysis we have done shows our exposure is upwards of 60%, if you count gilts, corporate bonds, private equity, infrastructure and real estate.

"So we need to be a little bit nuanced about what the opportunities are, and my request is if we do get a co-ordinated [growth investment] approach we are smarter than looking at just the equity market."

Local Pensions Partnership Investments' Richard Tomlinson pointed out the non-financial benefits of the UK's growth agenda. "Is it possible that you can end up with improved ESG characteristics for your portfolio [with UK investments]? It is possible," the chief investment officer said.

A bit glib

In addition, Tomlinson highlighted how many wide-ranging and varied areas are often cited within the economic growth investment debate. "There are some glib comments made, like putting money into venture capital. There is a huge deficit between the different asset classes and opportunities.

"People talk about investment in high tech, but it is a difficult skill set to invest in that successfully. So there is thinking more broadly about where you shift the needle as investors."

Fernando highlighted another concern. "One thing that does worry me is mandation of investment. Whether that is mandation by geography or asset class, I generally think you should let market forces play out and investors will choose the best risk-returns opportunities. If those are in the UK, that is fantastic," she said.

"We absolutely don't discriminate against the UK. We say we won't avoid the UK, but we don't favour the UK either. If the opportunities are there with the return profile, we will put assets to work there."

Fernando added that about 45% of Nest's illiquid assets are in the UK.

No mandate

As the arguments have evolved, the chancellor Jeremy Hunt has been keen to stress that although he wants greater pension fund investment in UK assets, he is not seeking to propose to mandate where pension funds should invest their money.

Although, ahead of the chancellor's Mansion House speech in July, reports suggested the chancellor is considering regulatory changes to help encourage UK pension funds into riskier, but higher growth, UK assets.

At the heart of the government's reasoning is the simple statistic that since the financial crisis of 2008 the proportion of UK equities held by defined benefit funds has fallen from around 50% to less than 10%. Over the same period, the proportion held in bonds has climbed from a third to more than 70%.

Tony Broccardo made an interesting point in regard to international investors. "Any UK investment vehicle should be just as attractive to overseas investors as it is to UK investors. We need that international validation," he said.

To add to the debate, the Tony Blair Institute has put forward a proposal to pool thousands of public and private pension schemes into "GB superfunds" that would invest in UK companies, start-ups and infrastructure. According to the *Financial Times*, the chancellor is "closely examining" the proposal.

FROM CHAOS TO CALM: LDI REVISITED

The legacy of last year's LDI crisis is still being felt in the pension funds arena. *Andrew Holt* heard some perspectives at the PLSA's investment conference.

The ramifications of the liability-driven investment (LDI) debacle of last year are still very much in the minds of institutional investors, especially pensions funds caught up in the chaos brought on by the Truss-Kwarteng mini budget.

It was a theme that was mulled over at the PLSA investment conference in Edinburgh in June. Offering a comment on the crisis, Matt Tickle, chief investment officer at Barnett Waddingham, said: "It was an interesting time. There were a lot of difficult decisions [to be made] at high speed."

Looking at where we are now, he said he had three observations. "First, is that LDI is still a sensible risk management tool," he said. "Within the weeks [of the LDI crisis] there were questions being asked around LDI. But fundamentally, it is about controlling real risks. And that is still the case."

He added: "When you get to the end of 2022 the majority of schemes got through the LDI crisis relatively unscathed. Their deficit position at the end of the year was, in most cases, less than what it was at the start of the year."

There are, Tickle noted, some outliers to that. "Some schemes that did not fare so well."

Sweeping statements

On the second point, Tickle addressed some problems that were reported connected to pooled funds. "Those sweeping statements were unhelpful. Because the research we have done since, there was not much difference in the outcome with and for pooled funds."

The third point was the difficult decisions made in a short period of time. "What we did was just go back to what clients wanted to achieve. What was their long-term objective? We spent time going through that. Sticking to what you wanted to achieve helped trustees to try and make those difficult decisions in the best way."

Serkan Bektas, head of client solution at Insight Investment, said the acceptance and importance of managing pension money was a big motivator in getting things right, given the responsibility such a job holds.

"To start with a statement of the obvious, it [the LDI crisis] was a dislocation all out of proportion, with rapid price action and also liquidity drying up quickly," he said.

Client holding

But he also made another point, about the noise created by the LDI crisis, highlighting that following the mini-budget and Bank of England intervention, gilt trading was about £5bn.

"Pension funds hold 80% of that £5bn," Bektas said. "So relative to gilt markets, this was nowhere near a mass exodus. We concluded that there was not an obvious trading solution. The focus had to be on clients holding on to their positions. Helping our clients to source and deliver collateral."

Interestingly, Bektas added that the experience was not as traumatic as you would expect.

"There were a range of experiences, and plenty to learn, but the response to that period was a pleasant surprise given the scale of challenges we faced."

Payam Kazemian, client director at Zedra Governance, said the whole pace of how events unfolded was the major issue. "What happened was an unprecedented movement in interest rate markets. But it wasn't the move itself, it was the speed at which it happened.

"Basically what that meant was it needed a lot of quick decisions in a short space of time which could have a drastic effect on the asset allocation of a particular scheme," he said.

There were also other challenging considerations. "To make it more complicated there was the communication piece from a trustee perspective. We had to make decisions while communicating," Kazemian said.

Liquidity issue

In addition, the often needed modification in asset allocation resulted in sharp allocation movements. "Sometimes the asset allocation ended up with a high percentage of illiquid assets," he said.

This has resulted in him thinking more about this. "The issue of liquidity now means going that bit deeper. Some extreme scenario analysis needs to be done on liquidity."

Kazemian also said the crisis revealed issues around governance. "What it pointed to was there were sometimes some weaknesses in the governance operational efficiencies on the boards [of funds] to deal with something quickly. So one thing trustees need to work on is reviewing those operational governance efficiencies."

Nike Trost, head of asset management and pensions policy at the Financial Conduct Authority (FCA), said the crisis raised issues for investors around risk modeling, communication and reinforcing Kazemian's point: about the operational constraints within extreme scenarios.

The FCA and The Pensions Regulator (TPR) have laid out their expectations on the future of LDI, mapping out how the market needs to evolve.

A big marking point has been the TPR has introduced a new minimum 250 basis points buffer, which must have scope to be replenished within five days. It also wants to see an operational buffer sufficient to cover day-to-day volatility.

PEOPLE MOVES

Dan Mikulskis has been appointed chief investment officer of The People's Partnership, the company which administers **The People's Pension**.

He joins in September from consultancy Lane, Clark & Peacock, where he is an investment partner.

When Mikulskis (*pictured*) takes up his new role, he will lead an investment team that oversees £21bn of assets for 6 million people, which the company expects will double to £40bn within five years.

Pensions consolidator **Clara Pensions** has appointed **Richard Zugic** as chief financial and operating officer.

The qualified actuary brings a quarter of a century of pensions and life insurance experience to the firm. Zugic is also a trustee of Abbey Life's defined benefit pension scheme.

He joins from Phoenix Group where he was the interim chief financial officer of Phoenix Re having previously been group chief actuary.

Professional trustee and pension governance specialist **Vidett** has strengthened its offering through a series of appointments.

The firm was established earlier this year following the merger of 20-20 Trustees and Punter Southall Governance Services.

Karen Wells joins as a client director in the London office, bringing more than 30 years of defined benefit and defined contribution scheme experience with her. Wells was previously a pensions manager at BMW Pension Services and was a principal at Mercer for 15 years.

In Manchester, **Caroline Eastwood** joins as client director. She was a senior pensions manager at Nationwide Building Society and before that the Skipton Building Society, where she supported trustees and sponsors in outsourcing the administration of the £8bn scheme. Before moving in-house, she was a member of the Mercer Governance Trustee Services team.

The Birmingham office welcomes **Claire Broadhurst** as a senior trustee consultant from Taylor Wimpey, where she specialised in governance for the £2bn scheme.

CALENDAR

Topics for upcoming *portfolio institutional* events:

13 September
– ESG Club Conference 2023

September
– Defined Contribution Roundtable

October
– Fixed Income Roundtable

November
– Sustainable Strategies Roundtable

Broadhurst has also been a pensions lead for LGSS, ensuring the employer's statutory responsibilities were met.

Finally, **Rich Ingham** joins the firm's London office as a senior trustee consultant from Mercer, where he was a pension consultant. Ingham has helped trustees and sponsors implement defined contribution strategies, negotiate parent company support packages, develop governance policies and manage schemes through to de-risking and wind up.

NOTICEBOARD

Workplace retirement scheme provider **Smart Pension** has committed an undisclosed investment to a new fund.

The AXA ACT People & Planet Equity fund has been launched to invest in companies making measurable, positive contributions towards the environment and society. AXA secured Smart's backing through its Sustainable Growth Plus fund.

The **Cambridge University Assistants' Contributory Pension Scheme** has appointed **Redington** as its strategic investment adviser.

The open defined benefit pension scheme manages £700m of assets for around 13,900 members, who are predominately support staff at the university.

Redington will assist the investment committee in its work to ensure the scheme meets all regulatory requirements. The consultant will also work to make the portfolios more sustainable, especially concerning the climate transition.

British Airways has retained PwC as an adviser to the trustees of its **New Airways Pension Scheme**.

The firm has advised the scheme's executive team and its actuarial and investment advisers for 15 years. It will continue to provide employer covenant advice on changing regulation, such as the new defined benefit funding code, as well as environmental, social and governance (ESG) issues.

The trustees of a pension scheme sponsored by financial services and insurance company **Marine and General Mutual Life Assurance Society** have signed an £80m buy-in **with Standard Life**. The deal, which covers the benefits of around 700 members of the **MGM Assurance Staff Pension Plan**, was announced in June despite completing in March.

Finally, the **Church Commissioners for England**, which manages a £10.3bn endowment fund, is to exclude oil and gas companies from its portfolio unless they are in "genuine alignment with a 1.5-degree pathway" by the end of the year. The ban stretches to all companies primarily engaged in the exploration, production and refining of oil or gas.

Following the decision, the Church is to exclude 11 oil companies from its portfolios which will see it cut ties with BP, ExxonMobil, Shell and Total as they are not aligned with the Paris Climate Agreement.

THE BIG PICTURE: DIVIDENDS UPGRADED AFTER STRONG Q1

The global picture: First quarter dividends by region ($bn)

Region	Q1 2022	% change	Q1 2023	% change
Emerging markets	$14.1	–1.8%	$17.3	22.7%
Europe, ex-UK	$44.3	10.6%	$60.3	36%
Japan	$4.4	–15.2%	$5.1	17.7%
North America	$155.2	12%	$168.6	8.6%
Asia Pacific, ex-Japan	$25.2	3.1%	$23.3	–7.4%
UK	$15.7	–15.6%	$15.3	–2.4%
Total	$258.9	7.3%	$289.9	12%
Divs outside top 1,200	$32.8	7.3%	$36.8	12%
Grand total	$291.7	7.3%	$326.7	12%

Source: Janus Henderson

A record dividend payout globally means the outlook for the year looks bright. But, as *Andrew Holt* finds, there are subtle anomalies in the numbers.

Global markets may be unpredictable but the dividend outlook remains positive, as record payout levels were the order of the day in the first quarter of the year.

Data from Janus Henderson reveals that 95% of companies worldwide either held or increased their dividends in the opening three months of the year, a period that saw a 12% hike in payouts to $326.7bn (£257.4bn).

This strong showing has triggered an upgrade to the asset manager's 3.4% full year forecast, with global dividends now expected to hit $1.64trn (£1.33trn) on an underlying basis, 5% higher than last year.

During the first quarter, Europe, ex-UK, led the way with 96% of companies increasing or maintaining their payouts in what is traditionally a modest period for boards returning cash to shareholders. Denmark, Germany and Switzerland accounted for three quarters of cash returns and saw one-off payments from Denmark's Moller-Maersk – the biggest payout in the world during the period – and Volkswagen.

The picture in the UK was different with total payouts 2.4% lower than a year earlier at $15.3bn (£12bn). This was largely due to a weak sterling as no UK company cut its cash returns during the period.

North America naturally takes up a decent chunk. It had another strong quarter returning $168bn (£132.4bn) to investors, 8.6% higher than a year earlier.

But the aggregate figure for the US can be misleading: special dividends from the likes of Ford boosted the headline figure, and the underlying trend shows slowing growth when you focus on ordinary dividends.

Still, 97% of US companies in the index held or hiked, higher than the global average, with strong contributions from real estate, technology and healthcare companies.

Max Cawthorn is head of capital strategy at the Pension Insurance Corporation

A SOCIAL VALUE OPPORTUNITY

There are more than 11 million people of pensionable age in the UK, which is expected to grow by more than 4 million by 2045. Ensuring the provision of safe, comfortable retirement accommodation for them is one of the big challenges – and opportunities – facing policymakers, planners, developers and the investment community. This demographic shift offers a growing landscape for investment in retirement living, which is an increasingly attractive market for institutional investors.

While the sector has recorded remarkable growth, untapped potential is increasing by the day as the population ages, but only 1% of residents over 65 live in dedicated retirement accommodation, compared to 6.5% in the US and 5.5% in Australia. By developing retirement communities in the UK to provide for 5% of people of pensionable age, the equivalent of £125bn in value could be unlocked.

However, there are significant barriers to investment in the sector, including a lack of provision for older people's housing in the local and national planning frameworks.

PIC has invested significantly in the UK living sector, including social housing, private rental and retirement communities. The increasing demand for retirement living creates favourable market conditions – with long-term planning horizons and consistent and predictable sources of revenue. So, this sector fits perfectly within PIC's investment strategy.

Generation of social value

Investing in retirement living offers secure cashflows over decades because it also delivers material social value by addressing the UK's housing crisis and expanding housing options for older individuals. Increasing the number of retirement communities is the cornerstone to unlocking every stage of the housing market. As retirees downsize to retirement homes, larger family-sized homes become available for younger families.

Yet today, as the tiny proportion of dedicated retirement homes in the UK suggests, the options for older people looking to move or downsize, without compromising on quality or comfort, are limited. Retirement communities provide a safe and supportive environment, countering risks of loneliness, isolation and abuse. Access to onsite medical facilities and wellness amenities reduces the burden on the NHS, with each person in a retirement home estimated to save the NHS and social services some £3,500 per year.

Investing in retirement housing also contributes to economic development and stimulates local economies by creating jobs and generating tax revenue. Retirement living can breathe new life into communities that struggle economically.

Case study

In June 2022, PIC demonstrated its commitment to retirement living by making an equity investment of up to £200m to fund the development and operation of several retirement communities across the country. Through the senior living investment partners' joint venture with Octopus Real Estate, PIC aims to provide homes for around 2,000 older residents, incorporating lifestyle and wellness facilities to enhance their quality of life.

This investment will generate predictable cashflows to back our pension payments, aligns with our purposeful investment strategy, and creates social value.

Conclusion

Funding and building new retirement homes throughout the UK benefits older residents and renters by providing them with a viable choice of housing of sufficient quality, designed with their changing needs in mind. It would support greater optionality and movement in the housing market by freeing up stock that may be more appropriate for families, but which would otherwise continue to be occupied by older couples or individuals.

With innovative financing solutions, PIC takes a leading role in embracing new ideas and re-envisioning real estate investment within the retirement living space, providing greater choice, quality and security of housing for older people. Growth in supply is dependent upon identification of the need for purpose built accommodation at a local and national level, and a supportive planning regime that helps to unlock sites and increase capital allocation.

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AN AMBITIOUS APPROACH TO CLIMATE CHANGE TARGETS

For UK pension funds, setting targets on any issue is never easy but is fundamental in order to make a system that it is better, and fairer, for all. Setting targets on climate change is no different, but it remains a key part of the investment governance process for pension funds. At NOW: Pensions we are proud of the steps we have taken to establish our targets on addressing climate change and the work we are doing to stay on track to meet them.

Guidance from The Pensions Regulator (TPR) on Task Force for Climate-related Financial Disclosures (TCFD) reporting states that targets should "for at least one of your metrics; reinforce risk management, be scheme-specific, and not be chosen arbitrarily".

While targets are non-binding, reporting on progress towards the target is required. If you miss or replace your target, you should be held accountable.

Target setting

Near-term targets typically include a percentage emissions reduction, a target year and a base year. At NOW: Pensions we have committed to a 50% emissions reduction by 2030 based on 2019 emissions, as a near-term target.

To track progress on this, setting a base year is important in order to hold yourself accountable and measure progress against the wider industry. The base year for countries is often when the countries' territorial emissions peaked. In the UK, the target is to reduce emissions by 50% by 2030 and by 78% by 2035, compared to 1990 levels. For investors, the base year is typically 2019 (due to the Covid 19 pandemic, 2020 and 2021 were anomaly years).

Longer-term targets can include the aim to meet the widely agreed commitment to net zero greenhouse gas emissions (not adding to the amount of greenhouse gases in the atmosphere) and by a pre-determined time. 2050 is often used because it is consistent with the UK government's target and the Paris Climate Agreement, internationally agreed in 2015.

Having targets is important because whether we as a society contribute to warming the planet by 1.5, 2 or 3 degrees, we will get to net zero; the real question is how long it takes us to get there. The longer it takes, the warmer the planet, and the higher the severity and frequency of weather-related events.

Targets may cover scopes 1, 2 and 3, which refer to the three categories of emissions:

Scope 1 – The greenhouse gas emissions a company makes directly through burning fossil fuels

Scope 2 – The emissions a business makes indirectly through using energy

Scope 3 – A combination of all emissions that an organisation can indirectly be responsible for across the value chain

While many pension funds continue to raise challenges around Scope 3, at NOW: Pensions we have decided to disclose our Scope 3 emissions data. Currently, our targets refer to scopes 1 and 2.

Investment and engagement

In our 2022 TCFD report, we committed to resist pressure to modify portfolios to meet headline portfolio-level decarbonisation targets at the expense of incentivising the real-world transition that is needed. Our goal is net zero greenhouse gas emissions globally – and we are seeking to maximise our influence to achieve this.

Theoretically, pension funds could decarbonise their portfolio almost immediately by selling their investments in high-carbon economies, such as emerging markets, or high-carbon sectors, which range from energy, utilities to mining, manufacturing and transport.

Indeed, emerging markets tend to have higher carbon footprints, in part because they produce carbon-intensive goods consumed by developed markets. They need capital to transition their economies.

However, rather than withdrawing from these holdings we, and many of our peers, use stewardship. We engage with companies and, through our third-party managers, vote at companies' AGMs, to encourage them (or if necessary, require them) to decarbonise more quickly.

Successful stewardship should include escalation (some companies may disagree with us). And so, we exclude some polluting companies, especially where there is little evidence that they will successfully transition, but our preference is, particularly in the first instance, engagement.

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INTERVIEW – JENNIFER DEVINE

"We are interested in real world change, not just making ourselves look squeaky clean."

The head of the Wiltshire Pension Fund tells *Andrew Holt* about private assets, building net-zero portfolios, looking to the future and trying to keep one step ahead of the government.

What's in your portfolio?

We are just over £3bn in assets and are pretty well funded. In the 2022 valuation, we came out at just over 100%. With gilt yields going up last year, our liabilities have come down and we are now around 120% funded. We are in quite a strong position at the moment.

We are in a phase of consolidation. In the three years prior to this, we introduced private markets for the first time. We have had property for a long time, but we have introduced private equity and private debt. They were new asset classes for us and we have been building them up slowly. They deliver similar risk-return characteristics.

We also have active equities through a balanced style portfolio and a sustainable one. We made the sustainable allocation off the back of our climate scenario modeling that showed it would give us better returns.

But it is growth orientated, so we have not put all of our active equities into it. We just went for a 50/50 split. We have Paris-aligned passive equities as well, which is quite exciting. That's aligned to a benchmark we developed with our pool, Brunel Pension Partnership.

We also hold some emerging market exposure. Emerging markets have quite a high carbon footprint and we could divest from that, but we are not willing to. We want to stay invested in these areas because we are interested in real world change, not just making ourselves look squeaky clean.

Our multi-asset portfolio holds equities and debt. We have, as I mentioned private equity and a dedicated allocation to renewable infrastructure and climate solutions, which we are going to build up over the next year or so. We also have multi-asset credit, lots of property and private debt. Then we have a little bit in gilts and an allocation to affordable housing. So we have a dual mandate of delivering returns and making positive social and environmental impacts.

> **We would be delighted to invest in UK infrastructure, but it has to give us the returns. That's the point.**

Why have you introduced the new asset classes to the portfolio?
The private markets are there to boost returns, but also to diversify.

How would you describe your investment strategy?
It is diversified and quite progressive. It has a lot of things in there that are looking to the future. We have a goal of having 30% of the portfolio allocated to sustainable or low carbon assets by 2030. And we are almost there. It's 28.2% at the moment.

The value of your fund has increased. What do you attribute that to?
It depends what period you are looking at. We are reporting annual accounts to the end of March now and we actually saw a bit of a dip during that year. It's been quite challenging. If you look back over the past four years, we were slightly in excess of the expected actuarial investment return.
A lot of that was driven by having good exposure to growth stocks and particularly some tech stocks, which benefited from the work from home trend.
In general, obviously less so over the past year, growth has done well historically and we have been overweight to it. But I would put it down to being well diversified. We do not tend to chop and change; we just strategically think where we want to be and sit there.

You have set a goal to reach net zero by 2050. How's that going?
When we set that goal, it was as a result of the modeling that showed the fund would be in a better financial position in a sub 2-degree warming scenario. That's why we set the goal. It was financially motivated.
We looked at a goal of net zero by 2030, but you just cannot get the investments to get to net zero by then and still get the returns. So we set 2050. We thought we'd align it with what the UK is trying to do overall and with the Paris Agreement. We are broadly on track.
We started off looking at our equity portfolios but have expanded it as the target applies to the whole portfolio. For our equities, we can look at the carbon footprint, the weighted average carbon intensity. In the other parts, like, for example, our property funds, we will look at the underlying funds and ask whether they have set net-zero targets for 2050 or sooner. In some ways we are tackling it directly through our allocation to renewable infrastructure and climate solutions.
We are setting engagement targets as well. We use consultants for this. They give us some analysis of what is in our portfolio and which investments are aligned, which are not and which are the heaviest emitters. Sometimes you don't just want to sell the heaviest emitter. It depends whether they have a chance to decarbonise and if they are going to change. We want to be financing that to make that change happen.
It requires quite a lot of in-depth looking at things from the bottom up. We have set the top-down target, but then we are looking into individual stocks and asking: "Why is that in the portfolio? Are we happy with it?"

You produce a stewardship report. What does that contain and why is it important?
The point of the report is firstly to share information on what we are doing in this area. But it is also in-line with the Stewardship Code's reporting requirements. We have to submit this annually to the Financial Reporting Council in order to maintain our signatory status of the Stewardship Code.
If you have read the whole report, they are chunky. So what we do is make a mini magazine to go alongside it, which tries to explain, in an easy to read way, why we do what we do.

What do you see as your big challenges on the economic front and how will these shape your investment strategy?
Inflation is the big issue. We are going to have to re-run the modeling to see if we are cashflow positive or negative. This is super important to us as a pension fund because

it can impact the strategy. We have a lot of money tied up in private markets.

There have been issues with some pension funds wanting to exit the pooling system. Do you understand why?

I don't know the details of it, but I believe they have not transitioned any assets into the pool. So maybe they were just looking at their options. But for us, we have more than 70% of the fund in the pool.

There is absolutely no way we would consider anything like that. We are fully committed to pooling. It's certainly not something on our radar, even remotely.

So you have no problem with the government setting a deadline for the total pooling of your assets?

I guess they want to push some of the funds who haven't pooled any of their assets. In a way, it feels like a level of instruction we don't need. We are all getting on with it and trying to do what was intended. So maybe they should just leave us alone to carry on and do that in the best way for our funds rather than mandate deadlines.

What do you make of the government wanting pension funds to invest in line with their growth agenda, such as in infrastructure?

This has raised its head again and again over the years. They don't want to tell us what to invest in, and they can't unless they change the regulations. But we would be delighted to invest in UK infrastructure, but it has to give us the returns. That's the point. They somehow have to facilitate decent return opportunities for us to do so. Otherwise, that's going to compromise our investment strategies and end up being a bit of an own goal in the long run.

What do you see as being the biggest challenges for your fund?

The climate stuff is only going to get bigger and more intensive.

Everybody is talking about biodiversity as well, yet I feel the industry is struggling to find its feet in terms of what that means from a practical perspective. That is going to be tough to get to grips with.

There is a lot of stuff we are expecting to come out from government and it's waiting to see what that is. Sitting around in the short term and not being able to make decisions or waiting for all these consultations to land, but still trying to be prepared for them is quite challenging. I feel like we have tried our absolute best to get ahead on a lot of these things, especially the climate stuff, like we have been doing with Task Force on Climate-related Financial Disclosures reporting. We are trying to get ahead of it.

We have a dual mandate of delivering returns and making positive social and environmental impacts.

”

JENNIFER DEVINE'S CV

2021-present
Head of Wiltshire Pension Fund
Wiltshire Pension Fund

2018-2021
Head of Pension Fund Investments
Wiltshire Pension Fund

2009-2018
Responsible for alternative investments within the investment portfolio
Hampshire Pension Fund

2005-2009
Accountant
Mazars

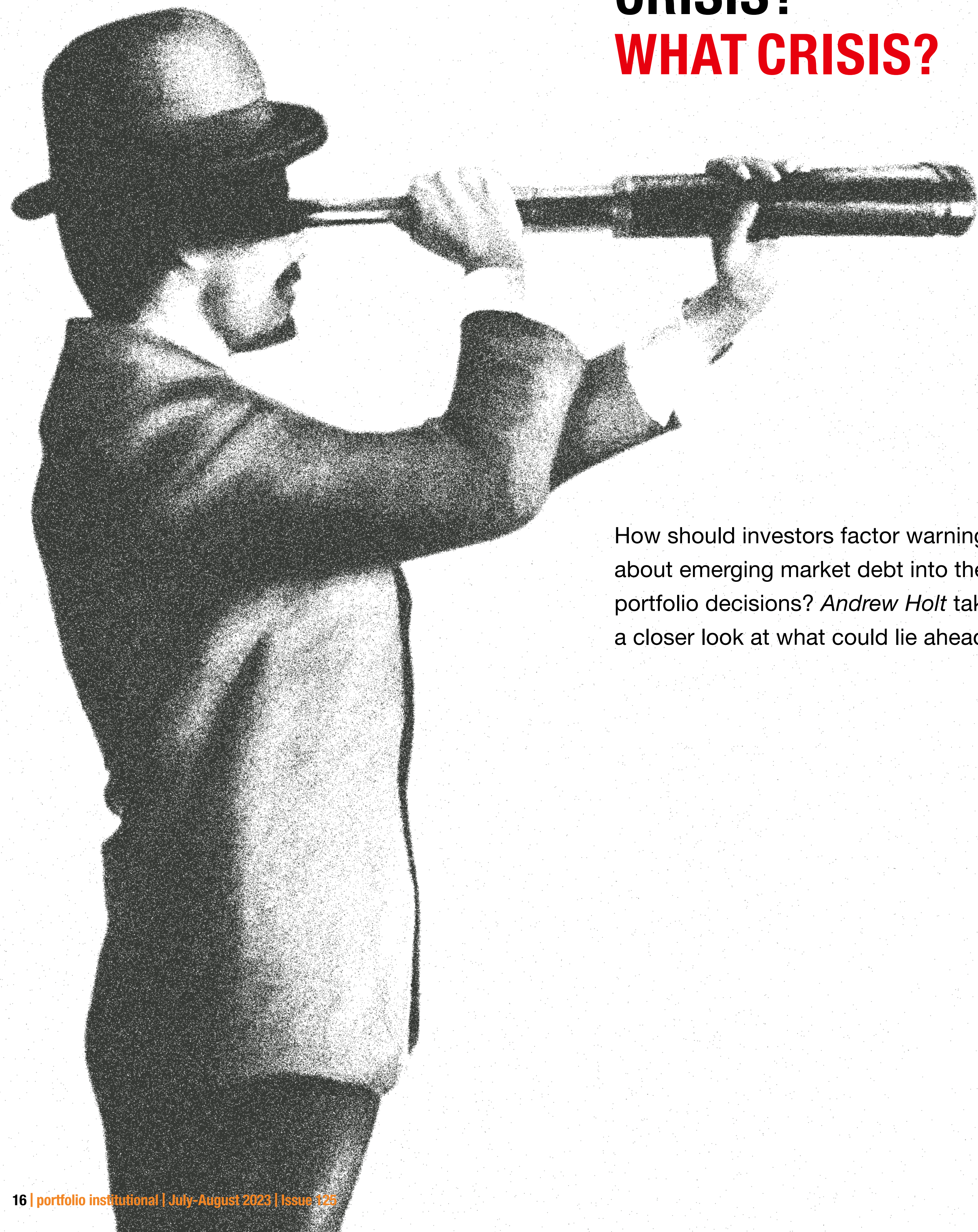
And what about your own biggest personal challenge?

I used to just work on the investments, but about 18 months ago I took over responsibility for the whole fund, including the administration. A lot of local government pension schemes have administration issues.

It can be done well and it should be done well. We can see how to get there but it can be difficult sometimes to get the skills in that you need. There are obviously challenges in the public sector with recruitment and things like that.

That is something the government has asked us to look at: coming up with workforce strategies and things associated with that. That's been quite challenging. It was discussed at the recent LGPS conference. A lot of funds are experiencing issues with backlogs of work.

That is my big focus. Getting us on top of that and operating efficiently on the admin side. Then with the investments, focusing on continuing to build on what we are already doing and advancing our responsible investment agenda.



EM DEBT: CRISIS? WHAT CRISIS?

How should investors factor warnings about emerging market debt into their portfolio decisions? *Andrew Holt* takes a closer look at what could lie ahead.

An underlying investment theme of concern is centred around a hidden, or not so hidden, crisis in emerging market debt. Is there a case for presenting such a narrative? The International Monetary Fund (IMF) has made a nod in this direction, estimating that 30% of emerging market countries and 60% of low-income nations already are in, or nearing, debt distress.

Total debt in emerging markets has hit a record high of more than $100trn (£78.4trn) – which amounts to a staggering 250% of GDP – up from $75trn (£58.8trn) in 2019. China, Mexico, Brazil, India and Turkey are the largest upward contributors, according to the Institute of International Finance (IIF).

There is no doubt that slowing global growth, high inflation and rising interest rates are squeezing emerging markets harder than more prosperous countries. And several studies of economic crises indicate that low-income countries are often most vulnerable to economic stagnation and financial crisis when global debt levels reach record highs.

This is a problem, says Jayati Ghosh, professor of economics at the University of Massachusetts Amherst in the US. “The Covid pandemic destroyed emerging market economies much more significantly than they did in the rich world. These countries were not able to bring about the fiscal response that was required,” she says.

Not systemic

This presents a possibly depressing picture. It implies that investors should not only stay adrift from emerging market debt, but emerging markets in general. But this crisis can be viewed in other ways.

“There is no systemic emerging market debt crisis at present,” says Greg Smith, a fund manager within the emerging market debt team at M&G. Although he adds: “Debt pressures have increased across the board since the pandemic.”

Similarly, Amer Bisat, head of emerging markets fixed income at Blackrock, says a new approach to emerging markets is needed, but not necessarily for the reasons emanating from a debt crisis. He suggests the emerging market debt debate should be viewed by looking at emerging markets over a longer timeframe, given these markets have radically changed during the past two decades. “A new mindset is needed when investing in emerging markets. The days where one invested in emerging markets as a ‘raw beta’ play are gone.”

Importantly, Bisat notes that changes in the emerging market landscape do not mean the asset class is not attractive. “EM 2.0, as we like to call it, still offers significant opportunities for potential durable returns. But investing in it requires a different investment approach.”

Navigating the markets

What is this magical new approach? “To successfully navigate the world of EM 2.0, investors must focus on differentiation, diversification, income, quality, disciplined risk management and rigorous research,” Bisat says.

But, as is often the case with emerging markets, he sounds a note of caution. “We believe it is tough to see an acceleration in capital accumulation in emerging markets, given continued de-globalisation pressures, rising levels of debt – that will make funding these investments harder to come by – and structurally higher global rates.

“Our judgement is that over the next decade we are more likely to see a gradual – though slight – worsening emerging market growth potential than to see a favourable reversal,” he adds.

This, along with the debt scenario, suggests that emerging markets may be a less thriving environment. And while Smith rejects the idea of an emerging market debt crisis, he concedes: “Despite the absence of a systemic crisis, several emerging markets are experiencing their own debt crises.”

There were six emerging market sovereign defaults in 2020, followed by Sri Lanka a year later and Ghana in 2022. “Which is a lot compared to infrequent sovereign defaults over the prior decade,” Smith says. Added to that is Ukraine, Russia and Belarus defaulting on their debt since Russia’s military aggression increased in February last year.

Emerging market dispersion

But given the changing nature of emerging markets, there are number of points to highlight. One is not all emerging markets are the same. “Our analysis shows that dispersion in emerging market asset price changes has already risen. We believe this trend will persist,” Bisat says.

His colleague, Tom Donilon, chair of the Blackrock Investment Institute, also expects a divergence in emerging markets, which has an impact from an investor perspective. “Some middle-income emerging markets, like Brazil and Mexico, may be able to ease policies and offset downward growth pressures. Others will engage with the IMF and absorb global shocks.”

But, he adds: “Emerging markets with elevated debt levels could be challenged.”

Yet there is a further note of concern. “We worry about a lack of global co-operation on debt relief – particularly between the international financial institutions, including the International Monetary Fund, and China,” Donilon says.

This is an issue that exacerbates the problem. The main vehicles for global co-operation – the group of seven (G7) and G20, along with the IMF – have limited tools to deal with a global debt crisis.

Market lever

But for all that, asset allocation within emerging markets is too important a lever for investors not to use. “It is our view that dynamic asset allocation across emerging market asset classes is an important return lever for those seeking exposure to emerging markets," Bisat adds.

In short, investors should not get bogged down by talk of an emerging market debt crisis.

In this way, high quality emerging market assets should be a core part of a portfolio. "Emerging markets is a wide-ranging asset class with ample high-quality names that may offer yield pickups to their developed market comparators," Bisat adds.

And despite the wave of sovereign defaults, they have not caused contagion, caused other emerging markets to "default like dominos", says Smith. In fact, he says: "Most emerging markets, especially those with investment-grade credit ratings, are in a much stronger position than they were in previous decades. They tend to borrow at home, rather than in hard currency, and have substantial foreign exchange reserves to buffer shocks."

This is extremely positive for emerging markets investors. Another reason for a more optimistic outlook on the asset class, despite the lurking debt crisis scenario, is that the majority of emerging markets have reached the end of their monetary policy tightening cycles.

A forecast substantial decline in headline inflation over the second half of the year should allow emerging market central banks to slowly commence their easing cycles. And fundamentals for the asset class have been fairly stable since the Covid-19 pandemic, particularly amongst lower-rated issuers.

Market debate

Another issue within the debate is often confusion about what constitutes the emerging markets asset class. This raises the question whether the term emerging markets is in fact redundant. To highlight this point, the official grouping from index providers, such as MSCI, contain a hotchpotch of countries from across the globe which often have little in common.

A striking change since the financial crisis of 2009 has been the rise, in index terms at least, of the two emerging market giants: China and India.

> **The days where one invested in emerging markets as a 'raw beta' play are gone.**
>
> Amer Bisat, Blackrock

China to 29% from 17% and India to 14% from 6%. The biggest losers have been Brazil (16% to 5%), South Africa (8% to 3%) and, of course, Russia (6% to zero).

This means that the famous acronym of 'BRICS' is pretty worthless as an assessment of emerging market potential given there are now only two left standing. Although it is safe to say that Brazil's President Lula is trying to change that.

Whatever the travails in China, its economy has at least been relatively stable and growing steadily, Covid lockdowns aside. But the makeup of its stock market has been transformed. In the case of India, its growth has been much more uniform.

History also has some lessons to teach investors when it comes to emerging markets. The central point is that it is vital to stick to countries which are well governed and avoid those which are not.

Emerging market vices

Aubrey Capital Management has been following this trend with interest. Those that cannot control "their vices, usually inflation, rampant corruption, or both," are doomed to remain "peripheral players, even if their populations and demographics suggest otherwise," says Rob Brewis investment manager at Aubrey.

Turkey is a case in point. The country was, and potentially remains, huge: a decade ago it was 2% of the benchmark and growing. Yet today it is 0.6%, and that is only after last year's Ukraine driven bounce – given it was a rare winner from the conflict.

Turkey has also voted "to continue its decline," according to Brewis, with the re-election of Recep Tayyip Erdogan as president. Russia, much of Africa and parts of Latin America remain locked in this same cycle, he says.

Furthermore, emerging markets are no longer driven by commodities, Brewis says, and are now "arguably inversely" correlated to them. Good news as commodities and inflation subside.

Another factor in the picture is that today's major emerging markets are considerably more resilient thanks to a better mix of industries: more domestic consumer driven, less commodity and export driven.

In addition, while balance sheets and returns are stable, it appears, Brewis says, that "cashflow is much stronger than it was in the past", which is good news as it means the next phase of growth can be more easily financed in most emerging markets. This offers a positive outlook – and one again far removed from a debt crisis.

Another factor is how developed market events continue to have an impact on emerging markets, according to analysis undertaken by Franklin Templeton. Although this trend is always going to be a factor given the power between the two markets.

The main influence has nevertheless been persistent inflation and what this would mean for future monetary policy tightening, as well as recessionary fears in the US and Europe.

Amongst the high levels of uncertainty, investment-grade emerging market debt returns year-to-date are above those recorded by high-yield issues: investors' "flight to quality" says Nicholas Hardingham, director of emerging market debt at Franklin Templeton, "results in a stickier, more supportive investor base for higher-rated bonds".

In this scenario on-going concerns about a global growth slowdown and tighter liquidity conditions have expedited another wave of outflows from emerging market debt and may limit the scope for fund flows into the asset class for the remainder of 2023.

Most emerging markets, especially those with investment-grade credit ratings, are in a much stronger position than they were in previous decades.

Greg Smith, M&G

Developed versus emerging

Comparing the wider macro-economic outlook of developed and emerging markets makes interesting reading when consulting the IMF's latest predictions. It says gross domestic product growth in advanced economies will slow to 1.3% in 2023 and pick up modestly to 1.4% in 2024.

The outlook for emerging market economies is stronger over the same period, with a growth rate of 3.9% in 2023, followed by an increase to 4.2% in 2024.

Greg Smith is also bullish. "2023 is set to have the strongest growth versus advanced economies for 13 years," he says.

Which could lead to the question: emerging market debt crisis – what crisis?

Emerging market securities attracted around $10.4bn (£8.1bn) in May, according to the IIF. Hardly the sign of a crisis, but…

"While our data shows a positive picture overall, this is the fifth consecutive month of China debt outflows and only marginal China equity inflows," says Jonathan Fortun, an economist at the organisation.

Inevitably, the wider global macro-economic outlook plays its part. Fortun adds the IIF maintains a view of lower inflation in the coming months for the US and a controlled landing of the economy, which may benefit emerging market flows overall.

"Emerging market local bond valuations have showed notable resilience this year, as slow growth and broad dollar weakness are driving returns," he adds.

"Sentiment toward emerging market local government debt has lost momentum, returns are sliding back into negative territory," Fortun says. "Nevertheless, we see an important rotation out of China debt. May's data shows an outflow of $7.2bn (£5.6bn) in China debt securities, making this the fifth consecutive month of outflows."

Fortun adds that term premiums have tightened sharply across emerging markets. "Yet as central banks shift their focus to growth from inflation, we see an opportunity for investors to take advantage of the context by receiving in the front end of local yield curves, which has benefited emerging market debt flows overall," he says.

Good shape

Fundamentally though, despite talk of a debt crisis, emerging markets remain in good shape with little deterioration in their creditworthiness, even as spreads widened significantly during the sell-off in 2022.

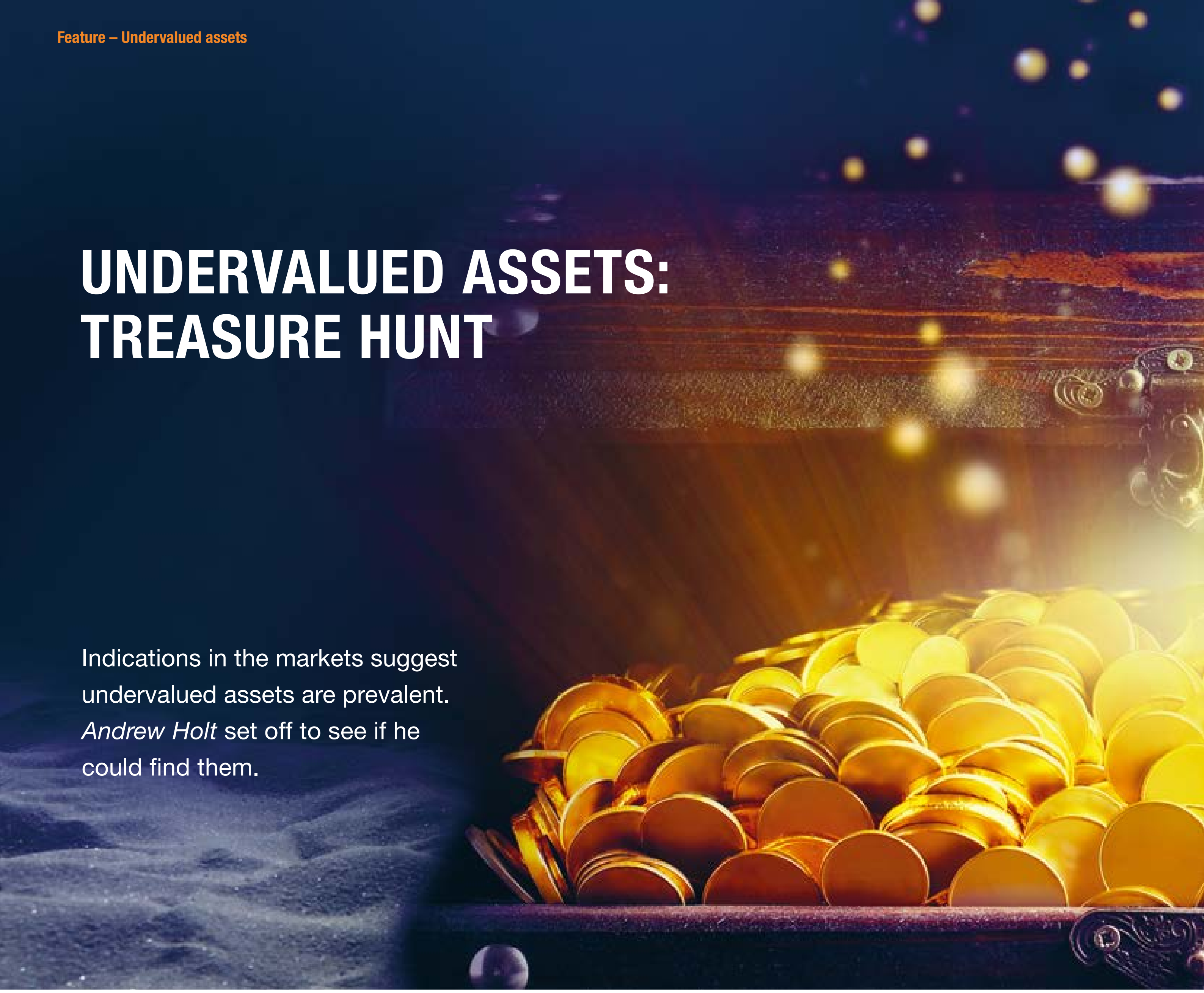
In this context, Hardingham remains "particularly focused" on attractively valued securities from issuers with "solid underlying fundamentals" and enough of a "buffer to withstand a period of higher global rates and/or loss of market access."

He also sees "some compelling opportunities" within the local-currency universe, particularly where higher nominal yields compensate for potential foreign exchange volatility, as well as amongst those currencies that have a lower correlation to the broader market.

Smith offers an even more positive outlook. "Emerging markets are the engine for global growth at the moment, while recession risks loom in the UK and USA."

But to take advantage of any opportunities, rigorous research is necessary. "Emerging markets are no longer a simplistic unidimensional thematic asset class," Bisat says. "Indeed, the new emerging market paradigm requires numerous asset allocation and bottoms-up security selection decisions."

Yet a debt crisis is something investors should not worry about in emerging markets.



UNDERVALUED ASSETS: TREASURE HUNT

Indications in the markets suggest undervalued assets are prevalent. *Andrew Holt* set off to see if he could find them.

Given the unpredictable nature of the markets, seeking out undervalued assets is an understandable pursuit. But market volatility and the subsequent falls in some asset prices have changed the game.

The upheaval that rocked the global financial markets last year is the principal catalyst behind some segments of the market being classed as undervalued.

But given the vastness of the investment universe, where should long-term, value-hungry investors look? There are, inevitably, different interpretations on which parts of the market are undervalued.

On a valuation basis, every sector across Morningstar's coverage universe trades below its fair value estimate. This presents a wide field. It also gives an insight into the damage done by the market volatility last year.

Based on such valuations, the group sees the best positioning for long-term investors in overweight value and growth stocks, which are 15% and 16% undervalued, respectively, and underweight core stocks, which are trading closer to fair value.

A closer look at specific sectors, show that small-cap stocks remain the most undervalued on a 25% discount to fair value. And the most undervalued category in the Morningstar Style Box is small-cap value, trading at an almost 40% discount to fair value – in what should amount to a significant attraction to investors.

Real estate also features within an undervalued assessment, having become even more undervalued, trading now at a 15% discount to fair value, according to Morningstar. Sectors such as industrials are trading close to their fair value estimates, while consumer cyclicals and communications look particularly attractive.

Health and wealth

US healthcare also offers an opportunity for investors, says Blackrock's chief investment officer of US fundamental equities, Tony DeSpirito. "He looked at the Russell 1000 for two years following the 'yield curve inversions' that appeared in the US market, and saw a "good performance from healthcare," he

says. "It is lagging so far in this cycle, which only makes for a more attractive entry point into a well-priced and recession-resilient sector."

Peter Abrahams, senior investment consultant at Lane Clark & Peacock, takes a diplomatic approach to the undervalued idea, while indicating there is indeed value in some assets within the market.

"While it's hard to describe anything as looking particularly undervalued at a time of economic uncertainty, where many assets have actually rallied so far in 2023, including a fairly narrow AI-driven rally in developed market equities, a couple of asset classes that may look attractive at present are short-dated investment grade credit, particularly in the UK, and Chinese equities."

For short-dated UK investment grade credit, given the significant rises in short-dated UK government bond yields, the total yield now available on "high quality UK names looks pretty attractive over a two or three-year horizon," he says.

However, Abrahams notes that with inflation looking 'stickier' in the UK than other major economies, there is the potential for mark-to-market losses if yields continue to push upwards. "For investors holding bonds to maturity, yields upwards of 6% per annum look an attractive return over a two to three-year horizon." Although an economic downturn more severe than expected could lead to a pickup in defaults.

Risk and reward

For Chinese equities, a short-lived 'post-lockdown' rally at the start of the year has given way to losses as many investors – particularly in the West – have exited positions, he adds.

On the China theme, Abrahams notes the appeal, albeit with qualifications. "While China has looked attractive on traditional valuation metrics for quite some time, clearly there is a high degree of political risk, surprise regulation and geopolitical uncertainty weighing on prices."

Having set out the China proviso, he sets out the China case: "Reasons to be positive in the short term however appear to be low inflation – meaning the Chinese central bank has scope to

> **While China has looked attractive on traditional valuation metrics for quite some time, clearly there is a high degree of political risk, surprise regulation and geopolitical uncertainty weighing on prices.**
>
> Peter Abrahams, Lane Clark & Peacock

stimulate the economy with cheap money – and China's high savings rate, which has traditionally been poured into a now-foundering property sector."

He also notes that "while the property sector presents a macro-economic headwind, the relative unattractiveness of the asset class to the domestic investor may mean greater inflows into Chinese equity over the near term, particularly as capital controls make it difficult for Chinese investors to access overseas securities".

Emerging value

Another keen observer on the undervalued nature of assets is Gustavo Medeiros, head of research at Ashmore, who says three emerging market asset classes remain "very undervalued". These he lists as: emerging market equities, emerging market local currency bonds and emerging market high yield sovereign debt.

Medeiros notes that emerging market equities are trading at a large discount to US stocks, which, is "not justified by fundamentals". Such equities account for 12% of the MSCI All Country World index, while 34% of the revenues from the indices are derived from emerging markets, that contrasts with the United States which accounts for 61% of the index, but only 31% of global revenues.

That is then reflected in the price-to-earnings multiple of MSCI Emerging Markets trading at 12.5 times earnings, much lower than the S&P500's 19.3 times. Moreover, there are specific opportunities within emerging market equities that stand out. Small and medium companies within the "technology supply chain in South Korea and Taiwan are interesting opportunities of capturing the future potential AI growth," he says.

Sharing Abrahams belief in the potential of China, Medeiros says Chinese stocks remain undervalued reflecting broad-based pessimism for the economy, even though policymakers stand ready to ease monetary and fiscal policies.

Large discount

In addition, Latin American stocks are also trading at a large discount to their historical valuations. The price-to-earnings multiples in Brazil, Chile, Colombia and Peru are between 1.5 and 2.5 below their 15-years mean and even Mexico trades at one standard deviation below its own mean, despite its strong macro performance and significantly benefiting from nearshoring of manufacturing production.

Not stopping there, Medeiros cites the South African and Malaysian stock markets as also trading at a large discount to their mean value. While Indonesia and India valuations are not necessarily "cheap, both countries have secular growth stories" that is likely to keep their equity markets as a bright spot in the medium to long term.

Within emerging market fixed income, emerging market local currency bonds are outperforming, rising 7.8% year-to-date with emerging market currencies rising by 2.7% against the dollar over the same period.

Here, an important factor is that local bonds are benefiting from the fact that most emerging market central banks were fast to react to inflationary pressures, with some hiking policy rates already in the first quarter of 2021.

This was in sharp contrast with the large developed market central banks that postponed their hiking cycle to 2022. And some analysts have noted that these developed markets are suffering now as a result.

The broader benefit is that inflation has declined first and faster in most emerging market countries. This means that some central banks, such as those in Brazil and Indonesia, are able to cut policy rates in the second half of 2023 while China and Vietnam have already started as their economies are affected by the slowdown in global manufacturing and poor sentiment.

US imbalance

Looking forward, Medeiros believes that the massively overvalued and imbalanced US dollar is "likely to sell-off", which should allow for further gains in emerging market currencies.

To complete the emerging market undervaluation outlook, several high-yield countries in the developing world are also trading at distressed valuations. The jury on whether these are "cheap" or "expensive" markets will depend on which countries implement much needed fiscal and economic reforms to improve their debt and balance of payments situation, allowing them to avoid a default or implement a "light" debt re-profile that leads to higher recovery value than today.

The recent currency depreciation in Nigeria and the appointment of a market friendly finance minister and central bank governor in Turkey are encouraging steps for these countries. Argentina is again in a perilous position, but the presidential elections may lead to a transition of power to a market friendly government which will focus on implementing fiscal consolidation and gradually removing capital controls which are "chocking the economy", a scenario far from being priced on Argentina's bond valuations today.

This amounts to a big list of undervalued opportunities in emerging markets. Why is this the case? Medeiros' research reveals that emerging market assets have struggled to attract significant and consistent flows during the past 10 years.

End of US exceptionalism

In this context, the balance of payment adjustment of 2013 to 2016 was followed by pro-cyclical policies by the US government that led to an exceptional amount of inflows to US capital markets, primarily stocks, explaining why the US has a $17trn (£13.3trn) net external liability to the rest of the world, which underpins the US dollar overvaluation. Over this period, the dollar outperformed significantly, leading to lower investments and GDP growth across emerging market countries.

If Medeiros is right: the poor performance of US capital markets in 2022 marked the beginning of the end of what has been termed US exceptionalism, which marks a massive development, way beyond that of market undervaluation.

It will mean investors need to diversify their exposure to other parts of the world. This will drive the US dollar weaker and the gap between "exuberant US valuations versus depressed emerging market valuations to narrow", Medeiros says.

This gives investors much food for thought. It also reinforces the fact that the identification of undervalued assets can spread far and wide and into unexpected areas. And the reasons can be beyond the recent market turmoil and focused on how an asset, or country, offers one of growth on its own terms.

In this way, Richard Bullock, geopolitical strategist at BNY Mellon Investment Management, puts the case for investors to look at Vietnam. "The Vietnamese dong is heavily undervalued, unit labour costs are exceptionally low, even by regional standards," he says, adding: "With the tightness of the labour market and growth in activity, real wage growth will be strong over time, boosting consumption. GDP growth is resilient and sustainable – at around 5% plus. And it is one of the only countries to avoid economic contraction during Covid."

Indeed, according to some estimates, Vietnam will become one of the 10 largest consumer markets in the world by 2030 – bigger than Germany or the UK.

We expect slowing growth and sticky inflation to bring greater dispersion between companies.

Helen Jewell, Blackrock

Market divergence

There is another dimension to the undervaluation argument in markets. This is simply that there can be a divergence of reasons for companies to be valued, with differences between stock markets justifying different valuations as well.

The high valuation on the US market can be seen as driven largely because its market contains several huge companies producing solidly growing earnings in high-growth sectors – inevitably in technology. Those are things investors are happy to pay high valuations for – or traditionally they have.

The UK, by contrast, is dominated by some sectors that are less highly prized, such as miners, energy companies and banks. These sectors have seen their valuations dip recently, contributing to the cheapness of the UK market overall.

Here numbers from Schroders show that valuations for companies in the UK materials sector are 22% below their 15-year average, which can also be thrown into the undervalues mix. Based on the same analysis, valuations on financials are 32% below and energy 33% below. Other indicators show a divergence between different areas of the market. Using an earnings-per-share measurement, for example, the FTSE100 is forecast to fall 2.9% in the coming year, while it is expected to grow 7.9% for the FTSE250 and 11.6% for the FTSE Small Cap. That could suggest it is Britain's smaller companies that have the best chance to raise their valuations from here.

But another view is the on-going economic environment will result in the undervalued trend continuing. Helen Jewell, deputy chief investment officer of EMEA at Blackrock, says: "We expect slowing growth and sticky inflation to bring greater dispersion between companies. This presents opportunities for active stock pickers to generate attractive returns – even if the market overall remains flat."

So the search for undervalued assets is something investors should be considering, if they have not done so already.

pi ESG CLUB

There is more than just salt in our oceans these days. Plastics and other pollutants are pouring into our rivers and seas at an alarming rate, threatening our safety. This month's ESG Club looks at how institutional investors can protect an important part of our ecosystem.

Members

AON · BlackRock · BNP PARIBAS ASSET MANAGEMENT · JUPITER ASSET MANAGEMENT · LGIM · Manulife Investment Management · M&G Investments · NEWTON Investment Management · PENSIONS AND LIFETIME SAVINGS ASSOCIATION

INSURERS QUIT NET-ZERO BODY

A mass walkout leaves the group's decarbonisation ambitions in tatters, finds *Andrew Holt*.

Support from insurers for the carbon-combatting Net Zero Insurance Alliance (NZIA) has collapsed like a house of cards. Lloyd's, the leading insurance market, has become the latest big name to withdraw from the group – a major blow to the United Nations-backed initiative, which could have far-reaching implications in the fight against climate change.

Lloyd's joins a heavyweight list of insurers, which includes AXA, Allianz, QBE, Swiss Re, Munich Re, Zurich, Hannover Re and Sompo, who have all withdrawn their support from NZIA.

The ongoing machinations in US politics are behind the evaporating support for the body. The decision comes after Republicans in the United States accused NZIA of violating US antitrust laws by effectively working together to reduce carbon emissions.

Via this law, the accusation is that the body corroborated in the intent of price-fixing and distorted insurance provision.

Stand against ESG

Some observers have noted that behind that accusation there is a wider Republican drive against financial institutions using environmental, social and governance-related (ESG) factors in their decision making – which, as any reader of *portfolio institutional* knows, is highly prevalent.

And a key point is all these major insurance groups have substantial business in the US. So faced with a threat to their operations or support for NZIA, it could be said there was always going to be only one winner.

It does mean the momentum built up by NZIA, after it was created at the Glasgow Financial Alliance for Net Zero at COP26 in 2021, could be lost.

Miqdaad Versi, a partner at consultancy Oxbow Partners, said the move by the insurers "does dampen the momentum surrounding NZIA and decreases the likelihood of collaborative efforts in the future."

And he added: "The big achievement of NZIA was the Target Setting Protocol v1.0 which laid out the approach for calculating targets for insurance-associated emissions to align to net-zero."

Darius Nassiry, vice president of climate, resilience and sustainability at sustainable energy group WSP, described the situation as worrying. "Climate change threatens to make the entire world uninsurable, so collective action is vital," he said.

Reducing climate risk

He added that a worrying development is that the work done by insurers to address climate investment risk could be lost. "Insurers leaving NZIA should keep their targets, because reducing climate risk in investments and insured assets is rational and necessary."

Gabrielle Siry, head of sustainable finance and European co-operation at the French Prudential Supervision and Resolution Authority, has estimated that climate change could mean costs doubling for insurance companies by 2050. "It means that insurers will need sufficient capital to face these risks and these damages," she said.

Dr Caroline Metz, senior EU policy officer at ShareAction, said there are clear lessons from the situation. "The decline of NZIA makes one thing crystal clear: voluntary initiatives won't deliver net zero. We need robust regulation."

MEP Henrike Hahn, shadow rapporteur on the Solvency II review for the Greens and European Free Alliance group, has already called for mandatory transition plans for insurers.

Capital charge

ShareAction is calling for the adoption of a one-for-one rule, whereby investments in companies involved in new fossil fuel projects would be subject to a 100% capital charge.

"Such a precautionary approach to how we regulate insurers' involvement in [new] fossil fuel projects would not only protect the insurance sector itself against unforeseen risks and losses but would also positively contribute to the green transition," Metz said. "That higher capital requirements for fossil fuel investments will also make it more costly for insurers to insure and invest in these types of projects."

The whole situation as it stands raises big questions about insurers, and with it other leading investors, committing to net zero objectives going forward.

Vipul Shetty, a specialist focused on the energy transition, said there have been flaws in NZIA's approach in regard to geographies.

"If NZIA is serious about transition they should realise that a global policy is never globally enforceable and that local environments in Europe versus Asia are very different from each other. Asia needs to transition in a different manner than their western counterparts, and for that, separate policies need to be created."

Remaining members of NZIA include Aviva, Generali from Italy and the French-based Credit Agricole Assurances. At one time, 32 insurers were members of NZIA.

INTERVIEW – PROFESSOR RICCARDO REBONATO

"A significant risk re-pricing may be overdue."

The scientific director of the EDHEC-Risk Climate Impact Institute and a professor of finance, tells *Andrew Holt* about why he is encouraged by efforts to address climate change, but says institutional investors should move from 'canned scenarios' and raises issues about carbon removal.

How well do you think institutional investors are approaching climate change and the risks associated with it?

There are many encouraging efforts to come to terms with the financial implications of climate change. Understanding what the climate future might look like is an essential first step in being prepared. Several international organisations have provided climate scenarios, which are invaluable.

However, so far these scenarios have been devoid of any assessment of their likelihood – relative or absolute – and this makes them difficult to use. Faced with a garden-variety market scenario, financial planners routinely build probabilities 'in their own heads' and qualitatively assess whether the scenario is worth losing sleep over or not.

But this is only possible because of a century-long experience of market crashes, credit crises, asset bubbles, interest rate hikes and the like. This 'institutional memory' is absent in the case of climate scenarios because we have not yet encountered this situation in the history of Western civilization, let alone of financial markets.

Any portfolio manager worth her salt can express an informed opinion about whether a market scenario such as 'yields move up by 100 basis points in a month' is reasonable or not – and she does not need to run a formal model to arrive at her conclusion.

So how can investors assess whether breaching the 1.5-degrees target in 20 years' time is likely or not?

This is why investors and financial planners need science-based models to assess what they should worry about and what belongs to the category of 'meteorite risk'. This lack of any probability assessment is a big gap in what is being provided to investors.

One should also keep in mind that standardised scenarios are great for comparability and reporting but can easily generate tunnel vision and encourage group think. The 'wisdom of crowds' is good indeed when it comes to estimating averages but fails badly when it tries to assess the tails of distributions.

So, my recommendation to investors is not to think that the 'canned scenarios' available cover all that can happen. Instead try to embed climate scenarios in the wider macro-financial picture. For instance, if subsidies prove more politically palatable than carbon taxes, and if subsidies – as it happening in the US and in Europe – acquire a progressively protectionist focus, what will the consequences be for trade agreements, globalisation, etc?

Or if the 150 million people living in the already extremely dry and agriculturally 'marginal' Sahel area were forced to migrate because of a modest temperature increase, what might the economic and political repercussions be for European countries?

Nobody can know with certainty how severe climate change in itself will be, but the nature of the problem is that it is deeply pervasive and has ramifications in every aspect of the economy.

How do you see the debate surrounding climate change, net zero and investors? Is it going in the right direction or taking the wrong course?

There is no doubt that emission abatement must play a key, and increasingly

important, role in controlling climate change. Investors can play a significant part in this respect.

However, every scientist and the Intergovernmental Panel on Climate Change agree that all paths to a manageable level of warming by the end of the century require substantial carbon removal. Unfortunately, we have very few practical carbon removal options, such as afforestation and reforestation, that can be deployed in scale now. Even the ones that we do have are no panacea, for instance, because of competition for land from afforestation.

Other removal technologies are expensive and require a lot of energy that must be provided by renewables unless we want to use up our carbon budget.

Unfortunately, talking about non-abatement routes to climate control is unpopular because of the perceived risk of moral hazard. However, if we fail to devote resources to direct carbon removal, the temperature outcome by the end of the century will be well outside the Paris targets.

So, we must indeed think of reaching net-zero soon – the sooner, the better – but we must start to think seriously about net-negative as well. All 'experts' agree on this point, but the importance of substantial carbon removal has rarely been on the radar screen of politicians, and, arguably, of investors.

The same investors should also realise that if the transformations of the economy associated with large carbon removal do not take place, then we should brace ourselves for much higher temperature outcomes.

Big transformational changes are afoot whether we act decisively or we don't. The net-zero target via abatement, useful as it is, can create complacency: it is a necessary first step but not the be-all-and-end-all of climate control.

You have studied the climate risk premium in detail: what it is and why should investors care?

All risk premia depend on whether the security in question pays well or badly when we feel rich or poor. Equities attract a positive risk premium because an equity portfolio pays badly when the whole economy is in the doldrums. Investors do not like these 'fair-weather friends' and, therefore, pay less for them – lower price, higher expected return.

Conversely, US treasuries and bonds attracted a negative risk premium up to the Covid crisis because they were perceived as providing a hedge to equity wobbles: the 'Greenspan put' – that is, to act as insurance by performing well when the rest of the portfolio was doing poorly. So, the same expected cashflows can be valued differently if they materialise in good or bad states of the economy.

Investors should care a lot about this because the risk premium can be a substantial part of the expected return from an asset. Indeed, part of the current high treasury yields in the US and the UK are due not just to inflation expectations but also to the fact that the negative risk premium has evaporated. This has happened because investors are no longer willing to pay an 'insurance premium' because the insurance policy doesn't seem to work anymore.

When it comes to hedging climate risk, when is it possible and when should investors do it?

If an investor has identified a robust hedging instrument, and wants to be insulated with respect to that risk, the hedge should be put in place as soon as the risk is identified. In some cases, deploying the insurance strategy continuously is too expensive: as in the case of out-of-the-money equity puts.

However, it is better to buy more out-of-the-money protection than to try to time the entry and exit points for the hedging strategy. Having said this, recognising that a portfolio is exposed to a risk factor, such as climate, doesn't automatically mean that the risk should be hedged away – it all depends on how handsomely the risk is rewarded and on the 'staying power,' such as internal or limit constraints, of the institution.

If an institution decides that it wants to 'ride the risk' – and extract the risk premium – then it should make sure that its risk-budget, for example, value at risk utilisation in 'normal times', is well below the limit. If not, the institution will see itself forced to liquidate the risky positions at the first sign of turmoil.

Therefore, are green assets hedging against risk or adding to it?
We have few empirical answers for this 'trillion-dollar question' and the empirical studies conducted so far have given contradictory answers. This is why state-of-the-art theoretical models can give investors some help.
Currently, a robust finding of these models is that the largest climate damages materialise if the global economy is firing on all cylinders: because of the link from economic expansion to emissions to concentrations to temperature increase to damages.
So, an asset that paid well in states of high climate damages, let's call it 'green', would pay well when equities pay well and would, therefore, attract a positive risk premium.
One important observation: investors must distinguish between risk premia ex-ante and ex-post. If a security is perceived to perform badly in poor states of the world, its lower price already reflects this information, and the investor, therefore, enjoys the positive risk premium today.
However, if investors realise tomorrow that the same security pays badly when everybody feels poor, then the downward price adjustment will only occur tomorrow, and today's holders will post a loss. There are reasons to believe that current valuations reflect climate risk partially at best: investors beware.

Can you explain the structure of the climate risk premium? Are long or short-dated assets more strongly affected?
As far as physical risk is concerned, the assets that could attract the highest risk premium – positive or negative – are long-dated, as it is long-dated cashflows that are more likely to be affected by physical climate risk.

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The sweet spot for physical climate risk premia is long, but not extremely long, dated assets.

Somewhat surprisingly, extremely long-dated assets – there are some treasury bonds with 100-year maturity – are not affected as much because, sooner or later, we expect the climate problem to be brought under control. So, the sweet spot for physical climate risk premia is long, but not extremely long, dated assets.

So how does the climate risk premium depend on what you describe as future abatement policies?
The climate risk premium depends crucially on future abatement policies. If we abate little, then climate damages are going to be much larger, and the climate sensitivity of cashflows – the 'climate beta' – to climate outcomes will also be correspondingly larger.
An estimate of the magnitude of the climate risk premium is, therefore, a joint estimate of whether the largest climate damages will materialise when the economy is strong or weak and of the aggressiveness of our climate policies. What I would add here is that the likelihood of abating too little is much, much higher than the likelihood of abating too much – so the risk premium has a similarly skewed distribution.

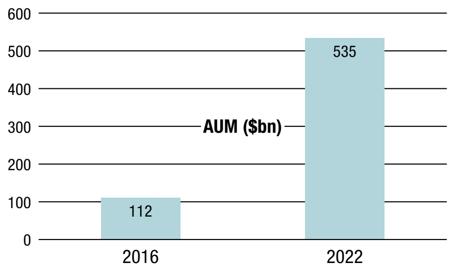
How robust then are the results to climate uncertainties and model limitations?
There is huge model uncertainty, and all projections should be associated with large error bars, which are too frequently forgotten. Having said this, we do have valuable information, and the defeatist view that the problem is so complex that models are of no use is not constructive.
The key trick is to use all the information we have while keeping in mind what we do not know. We should remember that knowing what we do not know is useful in itself.
Having said this, one of the most robust findings of climate/economy models is that we can expect the largest climate damages in strong states of the global economy, especially if robust growth occurs in yet-to-develop countries.
All models concur that the joint effects of demographic and economic growth of poor countries will have a profound effect on climate outcomes. What the models cannot tell us is whether this growth – if it happens – will be fuelled by renewables or fossil fuels.

You have mentioned that the market may be asleep at the wheel on climate change: what do you mean by that?
If we do little to tackle climate change and keep on kicking the climate ball into the high grass, temperature increases can take us to levels never seen by Homo Sapiens. Just 3-degrees would be unchartered territory. If, instead, we get our act together and act decisively, the whole economy will have to be rewired – profoundly and in a short time.
Either outcome should have a marked effect on valuations, either in the aggregate or at the sectoral level. Yet, the signature left in asset prices by these events is barely detectable. This makes me think that a significant risk re-pricing may be overdue.

INVESTORS' TOP SUSTAINABLE INVESTING CHALLENGES

Investors in Europe, the Middle East and Africa (EMEA) are increasingly turning to index investing to help them incorporate sustainable considerations in their portfolio.[1]

EMEA assets in sustainable indexed products (ETFs and index funds) have more than quadrupled since 2016



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

Here are the top challenges for European investors who incorporate sustainability considerations into their portfolios.

1. Evolving your portfolio

Tailoring a portfolio to improve specific sustainability characteristics can be time consuming, and the implications of incorporating both the financial performance and desired sustainability profile for the portfolio may be unclear.

Our approach: iShares offers transparency for investors across all our sustainable ETFs. Investors can:

- **Evaluate** a fund based on various sustainability as well as financial characteristics on iShares ETF product pages.
- **Build** a portfolio using iShares' range of sustainable ETFs, with the opportunity to replicate a non-sustainable benchmark or fund.

Risk: The environmental, social and governance ("ESG") considerations discussed herein may affect an investment team's decision to invest in certain companies or industries from time to time. Results may differ from portfolios that do not apply similar ESG considerations to their investment process.

2. Making sense of the data

Investors must be able to access and interpret ESG data so they can assess the measurable sustainability characteristics of their investments.

Our approach: At iShares, we believe standardisation of ESG data across the ETF industry will bring consistency and transparency to all investors.

- Our global in-house risk management platform encompasses over 10,000+ ESG metrics from a range of third-party data providers, so that investors can access aggregated ESG data for each of our iShares sustainable fund ranges, and compare our ETFs to make informed and transparent decision-making.[2]

Risk warning: While proprietary technology platforms may help manage risk, risk cannot be eliminated.

3. Choosing the right product

To help meet investor demand, sustainable funds have been launched in Europe in the past year with various methodologies.[3] With so many sustainable products to choose from, investors need clarity to navigate the options.

Our approach: To help investors choose an ETF that aligns with their investment and sustainable goals, our iShares sustainable ETFs are grouped according to four approaches in BlackRock's Sustainable Investing Platform:[4]

Screened	Funds that constrain investments by avoiding issuers or business activities with certain environmental, social and / or governance characteristics.
Uplift	Funds that commit to investments with improved environmental, social and / or governance characteristics versus a stated universe or benchmark.
Thematic	Funds that target investments in issuers whose business models may not only benefit from but also may drive long-term sustainability outcomes.
Impact	Funds that commit to generate positive, measurable and additional sustainability outcomes.

As at December 2022.

Spotlight: fostering innovation in sustainable fixed income indices

iShares work closely with index providers to offer ETFs that follow rules-based methodologies providing consistency across asset classes, while focusing on innovation.

One way iShares continues to innovate ETF methodologies is by introducing our first Paris-Aligned Benchmark (PAB) corporate bond strategy. The PAB requirements set by the EU help investors who seek to align with a decarbonisation pathway compatible with the objectives of the Paris Agreement.

This iShares PAB methodology is designed to align to the requirements of a Paris-Aligned Benchmark index, while remaining as close as possible to the corresponding non-sustainable index performance. This means that the risk profile can closely resemble that of traditional corporate bonds.

Sources: 1. ETF data from BlackRock, GBI, as of 31 Jan 2023, 2. BlackRock, as at 30 June 2021, EMEA Client Sustainability Survey, 3. Sustainable UCIS ETFs represented 58% of total flows in 2022 – BlackRock, as at 31 December 2022, 4. BlackRock, as at 31 Dec 2022

To learn more about investing in sustainable ETFs, search 'iShares sustainable'.

ESG: A SEA OF TROUBLES

Lakes and rivers across Britain are turning brown. Raw sewage is being discharged into our freshwater supply at an alarming rate. Indeed, in 2022 there were more than 389,000 incidents of untreated waste being flushed into the UK's waterways, say Surfers Against Sewage, a group campaigning for cleaner rivers, lakes and oceans.

The issue is that the UK's water infrastructure, which was largely built during the Victorian era, is unable to cope with the impact of warmer temperatures.

Hot weather followed by excessive rainfall makes it difficult for the ground to absorb water and it ends up overwhelming the drainage system. To stop water backing up in people's toilets

We don't just drink, bathe and swim in water, it is also a vital part of the Earth's life support system. *Mark Dunne* looks at how institutional investors can remove pollution from our oceans, rivers and lakes to build a sustainable future.

and sinks, water companies discharge the excess into rivers, lakes and seas through overflow pipes. Sounds a reasonable plan as no one wants their home or business to be flooded. Yet the issue is that along with the water coming out of those pipes is untreated waste.

This is not the only pollutant impacting the quality of our freshwater. Rainwater washes animal waste – which fuels the growth toxin-producing algae that draws oxygen away from animals and plants – and agricultural chemicals stemming from excessive use of fertiliser and pesticides from fields into rivers, while oil "runs off" roads into our freshwater supply.

This has left just 14% of rivers in England rated as being in a good ecological condition. The situation is so bad that there are fears Thames Water, which supplies a quarter of Britian's population, is on the verge of collapse.

The sewage scandal has put water issues on the front pages, which not only raises awareness, but could force companies to act. "You can have a conversation with a person on the street and people understand it," says Alexander Burr, ESG policy lead at Legal & General Investment Management (LGIM). "It is unfortunate that it has had to go this far. However, with the increased attention from stakeholders across society, we believe action must be taken."

It is not just the inconvenience of swimming through raw sewage that is the issue. Water may cover 70% of our planet but only 3% of it is drinkable. Supply is finite and with the population growing, so will the demand for water to drink, bathe in and to grow more food. Pollution, therefore, means poorer water quality, shortages and less nutrition.

Ocean drive

Yet this does not mean the pollution in our oceans is not as big an issue because we don't drink it. The situation here could be worse as it threatens our existence in other ways.

The oceans cover around 70% of our planet and we would struggle to survive without them. Not only do they generate half of the oxygen we breathe, but they also clean our air, feed us and provide millions of people with a livelihood.

The oceans influence our weather by storing solar radiation and distributing heat and moisture around the world. They are also a carbon sink, drawing the harmful gas out of our atmosphere, making it a natural ally in the fight against climate change.

This shows that land management, water and climate change are interconnected, Burr says.

Indeed, burning fossil fuels does not only impact our atmosphere, but our oceans too. The seas absorb around a quarter of man-made carbon emissions, which makes it more acidic. This alters the chemicals in the water, which many plants and animals rely on. For example, mussels, clams and coral need calcium carbonate for their growth, the level of which falls as water becomes more acidic. Rising acidity also makes it harder for some fish to sense danger or hunt prey and bleaches coral reefs.

"Water is one of those issues where the risks are extremely diverse, cutting right across areas such as climate change, nature, health and human rights," Burr says.

Plastic not so fantastic

Then there is plastic. It is not biodegradable and is, therefore, here to stay. Plastic entangles marine life and is eaten by fish and seabirds after entering the sea directly, through sewers or is washed off roads and into rivers and lakes during storms.

Indeed, 8 million pieces of plastic make their way into the ocean every day, killing 100,000 marine mammals and turtles and 1 million sea birds each year, according to British government figures from 2018.

One in every three fish eaten by a human contains plastic, says Surfers Against Sewage. Indeed, plastics, albeit microparticles, have been found in people's stomachs.

Another issue is that pollution in our rivers and seas is creating drug-resistant germs. Along with the food chain and drinking water, rivers and seas could be a breeding ground for anti-microbial resistance.

This could increase instance of people becoming seriously ill and even dying from a cut on the finger or a graze on the knee as drugs fail to kill any bacterial infection they cause. You also need antibiotics for operations and to help mothers give birth.

301 billion reasons to keep it clean

"Water quality and quantity is not currently as central in investment and corporate decision-making as it should be. This needs to change," Burr says.

In 2021, CDP estimated that $301bn (£237.5bn) of value is at risk if corporates do not improve and innovative around their use of water.

Whilst water has implications for corporates, there are also macro-economic impacts to consider. For example, the World Bank has highlighted that in some regions, water insecurity could cut economic growth by as much as 6%.

"Lack of action may be due to water risks occurring further down supply chains, across markets, making it an indirect and harder to evaluate issue. The value and impact of water is often not reflected in its price, so the negative externalities created in the water system go unallocated and unaccounted for," Burr says.

He adds that for water to be considered when pension schemes and insurers make investment decisions, it must be pointed

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Alexander Burr, Legal & General Investment Management

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>
> Alexander Burr, Legal & General Investment Management

out why it could be financially material, and what impact it has for them over the long term.

But one of the issues is that water risk cannot be tackled at the corporate level. "Companies around the world may be limited in the changes they can make due to many countries' water systems being nationalised or heavily regulated," Burr says.

"We have to tackle this at the policy level as well," he adds. "While one water company changing its own practices is, of course, a positive step, you also need policy-level change to tackle the national and global problems that we are seeing."

LGIM has been working to address numerous issues in this area. It worked in a collaborative engagement led by First Sentier Investors to reduce microfiber and microplastic pollution in the water system.

The engagement focused on asking washing machine makers to include filters in their products which can remove those microfibers and microplastics from our water system. "This has been quite a successful engagement," Burr says. "It demonstrates that change on our water system is doable."

LGIM is focused on improving water quality and quantity. One aspect is utilising developing disclosure frameworks. "Greater transparency across the entire supply chain will highlight areas for corporates who could address their water-related dependencies, impacts, risks and potential opportunities," Burr says.

Time for an upgrade

One criticism of water companies is that they been paying high dividends while pumping untreated waste into our rivers, lakes and seas. Indeed, they collectively returned £1.4bn to shareholders in the year to the end of March 2022. This may not look good to consumers whose health is being put at risk. But water companies could argue that they have a relatively fixed customer base, so outlooks rarely point to growth. Dividends are, therefore, needed to attract the investment needed to upgrade their aging infrastructure.

Chief executives taking home huge bonuses while their companies are being criticised by consumers and the regulator is a different issue. Indeed, Thames Water came under criticism for offering its now ex-boss a bonus despite leakage from the company's pipes being at a five-year high and the company struggling to manage its £14bn debt.

Water companies need investment and lots of it to fix their creaking infrastructure. Ofwat, which regulates the water industry, has proposed that £1.6bn of work upgrading the water system should be brought forward from its intended 2025 to 2030 schedule.

More than £1bn of this will be invested in reducing the average storm overflows by 10,000 a year. Nowhere near the more than 300,000 spills recorded last year.

Ofwat says that only 60% of the £2.2bn water companies could have invested in improving the infrastructure has been used for such a purpose.

Indeed, the largest 10 water companies spending in their wastewater infrastructure has fallen to an average of £2.7bn a year since 2020 from £3bn in the previous decade, Ofwat says.

Water companies in England and Wales only upgrade 0.2% of their assets each year, which is behind the 0.6% average in Europe, says Water UK, a lobby group. Only Ireland and Hungary achieve less.

An example of the size of the problem can be found in Oxfordshire. The cost of improving a treatment plant in Witney to stop sewage being pumped into the Thames has almost doubled to £17m from £8.8m. Energy and labour have been cited as why costs are spiralling higher.

But solving these problems is not just down to utilities. Steps have to be taken to reduce the agricultural waste that falls into our water system and removing the oil and plastics from our roads.

"There is, without a doubt, a need for greater capital investment and we are certainly seeing that coming this year," Burr says. "Don't get me wrong, that's great, but the historic lack of investment has meant that more is needed to improve pollution but also address the scarcity issues.

"This needs to be a long-term investment maintained over a number of years to improve the situation, which has been caused by an historic lack of investment," he adds.

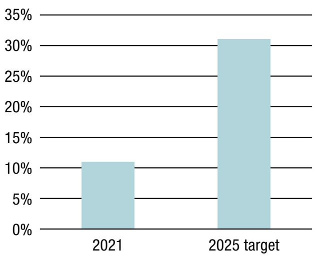
It appears that whether we are discussing cleaning up our sources of freshwater, or removing plastic and oil from our oceans, there is no quick fix to these problems. It will take a great effort from investors to create the changes needed to systems and corporate behaviour. The consequences of failure could be catastrophic.

Michael Rae is a climate solutions fund manager at M&G Investments.

WHEN POLICY MEETS ACTION: SEISMIC CHANGES IN THE PLASTIC RECYCLING MARKET

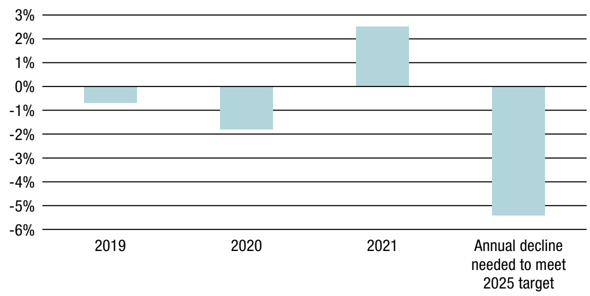
With many companies trailing their targets for reducing new plastic use and increasing the recycled contents of packaging, governments are implementing more ambitious targets for the use of recycled plastic content as the plastic packaging market continues to grow. Pyrolysis, a form of chemical recycling, could offer an innovative solution for dealing with hard-to-process mixed plastic waste.

Recycled plastic – current use and targets



Average current recycled content used in plastic packaging

Changes in virgin plastic packaging production



Annual change in virgin plastic packaging production.

Source: Global Commitment Report, Ellen MacArthur Foundation 2022.

Few industries receive an independent report card as rigorous as that of plastic packaging. One of the most prominent reports on the state of plastic recycling, published in November 2022, makes for grim reading. The Global Commitment Report, released by the Ellen MacArthur Foundation – which promotes a transition to a circular economy among businesses and policymakers – covered progress towards long-term industry targets of reducing plastic use and boosting sustainability.

Under the 2025 targets, committed to by six of the world's top 10 fast-moving consumer goods (FMCG) companies, virgin plastic used in packaging must decrease by 5% per annum by 2025. Yet this has been roughly flat in aggregate since 2018[1].

> **Whilst the mechanical recycling value chain has grown impressively to deal with specific waste streams, we now need innovative pyrolysis solutions to deal with the rest.**

Some headway is being made on raising the recycled content used in packaging. But with the top FMCG companies using an average of 11% in their plastic packaging, they must roughly double their rate of progress, on average, to meet their mid-decade commitments, which range from 25% to 50%.

The wider statistics which illustrate our growing dependence on plastics are eye-popping. Around 40% of the plastic the world has ever synthesised has been made in the past decade. Nearly half of this plastic is used for consumer packaging, around 95% of which is discarded after a single use, by design, according to data from the Ellen MacArthur Foundation. Despite growing awareness of poorly managed plastic waste, the problem is set to get worse. Even if growth in global plastic consumption slows to half its trend rate, the total market size is still estimated by the International Organisation for Standardisation (ISO) to increase by more than 2.5 times by 2050.

Global policymakers are responding to the challenge

The scale of the challenge is not lost on policymakers the world over. The EU has set ambitious targets for the recycled content in all plastic, and a recycling capture rate of 50% of all plastic waste by 2025.

This is more than just vague target-setting. A levy of €800 (£688) per tonne has been applied to all non-recycled plastic packaging waste since January 2021, although it is up to member countries to decide how to implement it. The choice is whether it lands on petrochemical companies, packaging compounders, FMCG companies or directly on the consumer.

Elsewhere, the US is targeting 30% recycled content in plastic packaging by 2025. China has also made some initial moves, by banning the import of unsorted plastic waste in 2018.

Seismic changes

We believe the combination of the demand 'pull' from FMCG companies and regulatory 'push' will lead to seismic changes in the petrochemical industry during the coming decade. Today's plastics value chain is built around multi-billion dollar assets, converting fossil fuels into plastics, in a largely non-circular fashion. But beyond 2030, it is estimated that all of the incremental plastic required

by the world will come from mechanically or chemically recycled sources.

Mechanical recycling is the easy bit. This involves collecting, sorting, cleaning and re-melting certain categories of plastic. It is mainly used for PET (clear drinks bottles) and HDPE (cloudy milk bottles). Because it doesn't change the chemical composition of the plastic, mechanical recycling is a relatively simple process. It also generates fewer GHGs than virgin plastic, by up to 80%.

The disadvantage is it cannot deal with mixed plastic waste, so requires extensive sorting and the plastic must be relatively clean. Furthermore, each re-melting results in the plastic degrading and being downcycled, so it usually results in a different end use, such as plastic bottles becoming carpet fibres.

The opportunities in chemical recycling

The answer to addressing a wider range of plastic feedstock lies in 'chemical' recycling, which itself breaks down into two broad technologies: 'pyrolysis' and 'monomer' recycling. Our analysis leads us to be more excited about the former, since it is a plug-and-play solution which provides circular feedstock to existing, naphtha-based petrochemical complexes.

Pyrolysis breaks mixed plastic waste back into its original hydrocarbon building blocks using heat, in the absence of oxygen. For some plastics, it can produce higher greenhouse gas (GHG) emissions than using virgin resin, because it requires high temperatures. However, it is still better for the environment, when accounting for the fact that much of the plastic feedstock it uses will either be burned in waste-to-energy facilities or left to slowly decay in landfill. Furthermore, plastic manufacturing accounts for around 8% of oil usage, so any growth in plastic demand which is not satisfied by a circular solution will require a corresponding increase in upstream oil development.

There are several other benefits. Pyrolysis can be applied to the plastics which don't have established mechanical solutions (such as low-density polyethylene, polypropylene and polystyrene), and its great advantage is that it can process labels, inks and food residue, so requires less sorting and cleaning. Pyrolysis-derived naphtha also produces new plastics which are chemically identical to those synthesised from fossil fuels. This means they are free from the degradation common in mechanical recycling, and they are suitable for food-grade applications, which is key to FMCG company interest.

The economics, currently, are also strong. Demand for circular feedstocks far outstrips supply, so circular plastic sells at a premium to virgin, while in some cases the feedstock of part-sorted plastic waste is available at a low, or even potentially negative cost (if the seller is otherwise faced with landfill fees).

Some serious targets are now emerging from the petrochemical industry, which will support growth in the pyrolysis industry this decade. TotalEnergies produces 60,000 tonnes of high-value circular polymers today and targets 1 million tonnes in 2030. Similarly, INEOS aims to incorporate at least 850,000 tonnes of recycled and bio-sourced polymer into products by 2030, from close to zero today. Both companies have announced pyrolysis partnerships with M&G Catalyst investee company, Plastic Energy.

In conclusion

We are all in the habit of putting all plastic containers in the correct bin, and assuming the recycling industry will do the rest. But whilst the mechanical recycling value chain has grown impressively to deal with specific waste streams, we now need innovative pyrolysis solutions to deal with the rest. This is the route to raising the 14% of plastic which is currently recycled towards the 70% to 80% seen in the paper and glass industries, levels which are now explicitly targeted by industry and policymakers.

1) Ellen MacArthur Foundation, "Global Commitment Report 2022", (ellenmacarthurfoundation.org)

M&G Investments

Joe Dabrowski is the deputy director of policy at the Pensions and Lifetime Savings Association

POLICY CERTAINTY AND INCENTIVES ARE THE BEST WAYS TO PROMOTE PENSION INVESTMENT IN UK GROWTH

At the start of June, the Pensions and Lifetime Savings Association (PLSA) hosted some 800 pension and investment professionals in Edinburgh for our annual investment conference.

Over two-and-a-half days we heard from more than 100 speakers across 42 sessions, covering topics as wide ranging as investing for a less carbon intensive future, liability-driven investment, post-retirement products and driving better value for money.

But the liveliest debate, and the one which had dominated the headlines in the run up to the conference, was about pension funds' role in driving growth in the UK economy.

Today, UK pension funds invest almost £1trn in the UK through a mixture of shares, corporate bonds, government debt and other asset classes. This investment generates the capital businesses need to expand their operations, hire more employees and develop new products and services. It also supports spending on infrastructure, renewable energy and social programmes.

However, during recent months there have been many public calls, from government, stakeholders and the media, for pension funds to play a bigger role in providing additional capital to support growth in the UK economy, especially through increased direct investment in infrastructure, private markets and venture capital.

Many commentators have suggested that the best way of achieving additional investment in UK growth assets is by undertaking radical and rapid consolidation of the pensions sector. We do not disagree that scale can have many advantages but, in our assessment, there are many quicker and simpler ways of achieving these objectives.

Initiatives to support pension fund investment in UK growth

In a new paper, *Pensions and growth*, the PLSA has identified a dozen opportunities to encourage all types of pension fund to invest further in UK growth. Importantly, these measures do not inhibit pension schemes' ability to direct the investment of their members private savings, and do not dilute their fiduciary duty to scheme members.

Chief among them is establishing a rich and continuous pipeline of enterprises needing investment for providers to bring to market and investors to choose from. The asset management industry should be encouraged to focus on sourcing UK opportunities and developing new investment funds and products (such as long-term asset funds) which are appropriate to pension fund needs. The British Business Bank could also be given an extended scope to support companies that need scale up capital, and to create or partner with funds that can bundle up the assets in a form that would be suitable for pension funds.

Initiatives like the Long-term Investment for Technology and Science (LIFTS), which alter the risk-return component of an investment, are appealing to pension funds provided the financial support from government is of a long-term nature. Enhancing the tax treatment of domestic investments, as they do in France and Australia, also merits exploration.

We also want to see the government press ahead with its welcome plan to increase auto-enrolment contributions by removing the lower earnings limit and by starting automatic enrolment at age 18 instead of 22. Only by increasing the flow of new assets into defined contribution pensions can we hope to provide more capital, and better retirement incomes, in the future. The government should also consider further increases in contribution levels from 8% to 12% during the next decade.

Arguably the most important thing the PLSA is asking of the government is policy certainty. Setting out a clear plan for the future of the UK economy, for example on the green transition, will help draw pension fund investment and allow the UK to compete with non-domestic assets.

Pension funds play an essential role in supporting the UK economy. The UK has one of the most sophisticated and mature pensions systems in the world – it is a great British success story, that provides security to tens of millions of savers.

How pension funds can play a bigger role in providing capital to support growth in the UK economy is an important question, and in our discussions with schemes there is a clear appetite to invest in the UK – where it is in the interests of savers.

Our proposals build on current government initiatives and address the needs of the pensions landscape as it is now. We risk unintended consequences by trying to radically reshape the market or water down the fiduciary duty that is fundamental to our system.

You can read the *'Pensions and growth'* paper at www.plsa.co.uk.

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

DISCUSSION: STEWARDSHIP

There was a time when an institutional investor owning equity in a company simply sat down with its directors to make sure they were managing their financial risks and to ask how much money they will make this year.
Things have changed. Savers and other stakeholders now want companies to be greener and more socially responsible and so are pushing those managing their retirement funds to create more sustainable portfolios.
Therefore, attitudes towards stewardship of the assets have changed, but how does this work in practice? *portfolio institutional* sat down with a panel of experts to find out.

How has the definition of stewardship changed since the first UK Stewardship Code was published in 2010?

Claudia Chapman: The code was initially a set of principles around how institutional investors should be the stewards of predominantly UK-listed equity. It was about making UK corporate governance more effective and thinking about the long-term sustainability of companies.

In 2019, we repurposed stewardship to serve the needs of pensioners and savers. For example, if being invested in a company is no longer in the best interests of your members, then you should divest despite the fact that it might mean the company fails.

We extended the definition beyond listed equity. Effective stewardship should be demonstrated irrespective of how your capital is invested. That might be corporate fixed income, sovereign debt, real assets, you name it.

We also saw that investment by UK asset owners in UK plc was declining, so it now covers wherever in the world you are investing.

It also considers decisions before you allocate to an asset, right through to holding and divestment, if that is necessary. Effective stewardship should have positive effects on the economy, the environment and society.

If the UK Stewardship Code has been rewritten for members, what does it mean to asset owners?

Jen Bishop: We see it as a risk management tool. It is a way to ensure that we are looking after all risks over all horizons.

Sometimes that can be conversations around why people are not thinking long term. Our members are focused on financial outcomes. They want to understand how an investment might affect wider stakeholders, but they also want to know how it will affect them, given that they rely on their pension income.

It is increasingly easier to tie environmental, social and governance risks to financial outcomes. Being able to prove that is helpful during conversations around fiduciary duty.

Michael Marks: Stewardship is about protecting our clients' assets. We bring a universal owner perspective to engaging with governments, international organisations or individual companies to raise market standards across the board.

To bring that to life, we engage with governments because they set frameworks. For example, when auto manufacturers were told that beyond a certain date they could no longer sell internal combustion engine cars, they replied that it was impossible to meet that deadline. The moment frameworks were put in place, however, it was amazing how quickly those companies changed their business models to address what was achievable.

Our clients expect us to think about the levers we have, which could be using our

vote or engaging with companies or governments on regulation and policy.

What role does Cambridge Associates play when it comes to stewardship?

Deborah Christie: On the manager research side, our role is to understand what people like Michael are doing in terms of engagement. How is it integrated into the fundamental analysis? Are they writing resolutions? Who are they collaborating with to raise the bar? This helps us to understand where many of the boutique managers we cover could collaborate with like-minded investors to effect change.

Our other role, as stewards of our clients' capital, is to help them understand where engagement fits into their investment policy. We then help select managers who are active in engagement. We work with clients to craft policies or letter writing campaigns or figure out who to collaborate with.

We come at it from both sides. Everything we do is customised to a client's interests and can range from social justice issues to climate to a just transition.

Deborah Gilshan: One of my favourite quotes on stewardship is in *Security Analysis* by Benjamin Graham and David Dodd: "The choice of a common stock is a single act; its ownership is a continuing process. Certainly, there is just as much reason to exercise care and judgement in being as becoming a shareholder."

We have to be careful not to make this something that is relatively new, because it is fundamental to good investing. The idea of a continuous process of ownership is an important way of thinking about this.

How receptive are companies to making big changes?

Gilshan: Stewardship has its limits. Companies do not automatically do what you ask of them and we can't keep engaging on an issue if they don't respond.

Remuneration is a good example. It is fascinating that we have a system where, when shareholders vote down an advisory vote, the answer is more engagement. Why would I engage further on a pay plan I voted against because it is not in the interest of my clients? That is a systemic issue in the stewardship chain that we need to think about.

Marks: Are companies willing to engage? Some are, some aren't.

We approach stewardship by looking at how we can engage with companies to help raise the bar across their sector and the country in which they operate.

We have had some successes, which are not solely down to us because stewardship is rarely an individual activity. In China, the government has set a 2060 net-zero policy. But through conversations in the country, we have companies targeting net zero by 2050.

This is an example of shareholder stewardship leading to an outcome that a company would not necessarily have planned for on their own. But some companies are reticent to engage, so we are not always successful.

Simon Rawson: My challenge is not getting BP and Tesco to the table. It is getting investors prepared to use their tools to deploy that stewardship, such as a voice at the AGM and a public voice, because the majority don't use them.

In our research on the world's 80 largest asset managers, 80% said they have private dialogues and send letters to companies, but the number who spoke at an AGMs falls to 25%. Those who have filed a shareholder proposal drop to 20%.

Shipra Gupta: There is no one-size-fits-all here. There are state-owned companies where there is most often a dismissal of engagement with investors, while there is dual class share ownership, so bringing about change in those companies comes with its own issues.

But equally, we have challenged companies on not having, for example, sustainability KPIs related to executive compensation, and they have shown great intent, asking us to share best practice with them. Another example is of a company where the board member responsible for diversity, equity and inclusion has proactively engaged with us. So there are nuggets of great examples of investor-corporate engagements.

The other challenge for investors is how do we use our limited resources to make the greatest impact. Is it by our largest shareholding? Or should we put our energies behind the companies which are the next size down from the mega caps, where arguably we possibly can expect to have greater influence?

Chapman: Because there are such high expectations of investors to tackle these issues, there is an assumption that you can be everything to everyone. But there is an opportunity to control that narrative.

We spoke to a small investment manager who has limited resources and is going to tackle mental health as "everybody's doing climate". They have identified mental health as a systemic risk and the UK Stewardship Code, by identifying systemic risk as a stewardship priority, has given them the mandate to have that narrative.

Perhaps the best use of your resources is to engage with regulators and policymakers to change the system, rather than having a one-to-one engagement with a company that is not going to respond.

Marks: Our role is not to tell a company what to do. We are not meant to steer the ship. But if the ship is struggling over something, such as remuneration, we want to be the tug that comes alongside and helps it to the shore.

We should engage on all of our selected topics. Asset owners may have different perspectives and prioritise less financially material issues, but as an asset manager, for each theme we focus on, I ask the team to answer: why does this matter to our clients as investors? If we don't answer that question, are we doing our job as investment stewards?

Bishop: There has been a setback on stewardship. It feels like some of the conservative voices in America have been so loud that some managers have significantly decreased what they are willing to do. We would have graded them A, B or C on stewardship a year ago, but now in some cases it is much lower.

The pushback on anything that can affect short-term profit is strong. Some managers are finding it hard to balance long-term goals with implication for short-term profits because the US has spoken loudly to them on this.

Where we were once trying to get managers to improve on stewardship, it is now a question of: are they doing at least the minimum?

Gupta: You have finite resources and want to push regulation and policy where it can help, but equally, in areas like the US, you want to engage with corporates to lead with best practice.

You need to support your managers, because they are under pressure from where they operate, and yet be the constant voice that keeps them honest on managing and mitigating sustainability risks.

Bishop: But because there are so many different areas of focus in ESG, and managers do not hear the same from all investors, this message can be diluted versus the strong anti-ESG message from some parts of the US.

Gupta: Look at reproductive rights. How far have we gone back? There are shareholder resolutions asking how reproductive rights are being protected. This is where corporates can be supportive against the policies of the state.

Stewardship is across the capital structure. It's not equity ownership, it's asset ownership.

Michael Marks
Head of investment stewardship and responsible investment integration
LGIM

But we hear from companies that their investors have told them to avoid long termism or climate change at this point in time. Who are these investors? Where is the transparency? For example, some big oil and gas companies backtracked on their climate transition plan within a year. Feedback from investors is why, but who are the investors who supported that change. The companies won't name them. This is where there is a lack of transparency.

Thankfully, the Financial Conduct Authority and the Financial Reporting Council i are helping with the anti-ESG rhetoric coming from the US. It almost feels like it is on Europe to drive the world forward because Asia has its own challenges and there is the element of a just transition and large state ownerships, and the US has political headwinds as mentioned.

Christie: In Europe, the regulatory environment and the goals of so many asset owners mean that everybody is rowing in the same boat. A lot of change and progress is moving in the same direction.

But you have to look at America from a different perspective. The idea of stewardship and even voting shares is so different today from 10 years ago. Nobody was talking about engagement 10 years ago and there were perhaps a handful of resolutions. In the past four years, however, the number of resolutions has quadrupled.

Shareholders are now more active because they care. They are voting because they want to see change. There is always going to be a two-steps-forward-one-step-back situation, but you cannot put that genie back in the bottle.

The managers I cover are putting lots of resources and people behind stewardship. Some, of course, are using it to say they are doing things that they are not, and there has been a backlash. But clients care about engagement, as so much of this is financially material.

This is a generational change. There is going to be a huge transformation and the investment managers I speak to want in on these opportunities. Portfolios are changing because ownership is changing.

> **Portfolios are changing because ownership is changing.**
>
> Deborah Christie
> Managing director
> Cambridge Associates

Gilshan: There are structural differences in the US that are worth reflecting on. It does not have regulatory-backed corporate governance or stewardship codes.

Investors engaging with independent board members of US companies is a relatively newish concept, but I would be careful not to present Europe as a panacea.

Marks: We are talking about the influence shareholders can have through engagement, but as an asset manager, are we doing what our clients want us to do? Are we voting? The answer is yes.

If we see an appreciation of our influence and if it creates engagement with our clients on a subject that they care about then that can only be a good thing. In fact, we are doing what we should be doing: listening to our clients because we are stewards of their assets.

Rawson: On the point around not having the bandwidth to engage with everything, I am sympathetic to that. But there is a system failure. While it is true that individual investors do not have the resources to engage across the portfolio, there is also no effective collaboration. It is not just fears of anti-trust. You hear it among UK investors who have no concerns around collaborative engagement.

All investors have a responsibility to vote their shares, regardless of whether you have engaged or not. If you have a group of investors who have been thoughtfully and transparently engaging a company on an issue over a period of time you need to back them when they put forward a shareholder resolution or advocate for a vote against directors.

The number one reason investors say they cannot back a shareholder proposal is because they have not engaged with the company. Well, you cannot engage every company, but you can listen to your peers in a non-competitive way and support them. As a whole, we can drive the system transformation that we need to see.

Are unified voices more successful in driving change?

Gupta: We are talking about system change. If a significant body of investors are having the same conversation, their voice is amplified and is taken with a certain seriousness. It is more efficient, more practical and it's pulling in the same direction.

We have seen some success, but there is more work to be done. It is a fairly new concept and so there are lessons to be learned, but it is happening.

That said, we have to be cognizant that there are instances where you might change tack.

We have fired managers who are failing to take material risks or opportunities into account.

Jen Bishop
Deputy CIO and head of responsible investment
Coal Pension Trustees

Sometimes when a group of investors are engaging, a company gets defensive.

It is then best to have those nuanced conversations one-to-one with a senior executive to find out what is happening within the business and how you can help.

Gilshan: There are a lot of great companies out there. Stewardship is about checking in and creating a long-term trustful relationship. But we have to acknowledge that not all companies are managing the transition or are diverse, and investors tend to focus on the ones where the most engagement is needed.

Stewardship, for me, is that long-term trustful relationship between investors and a company such that difficult conversations can be had and hopefully companies will respond.

Chapman: That's a good point. It is also good to change the tone of the conversation, which can sometimes be negative. For example, it feels combative when you are talking about the number of shareholders who voted against Shell's chair at the AGM.

There are positive conversations with companies, but they do not always come out when you are getting reports about how unhappy chairs are that nobody is knocking on their door to discuss the issues.

Marks: We want partnership-type conversations with the companies in which we are invested on behalf of our clients. There are also topics which we want to bring to their radar.

Roll back six or seven years, when we started our climate impact pledge, everyone was talking about the issue, but companies were not doing anything about it.

There is another issue which I do not believe companies across many sectors are paying attention to. It is financially material and is critical to our health: antimicrobial resistance.

We need more companies to think about it. We are talking to the World Health Organisation and the UN as much as we are to pharmaceutical companies, water companies and food companies.

It is shocking that prophylactic antibiotics are used in the food chain, weakening our resistance to diseases. The economic impact could be trillions of dollars if we find ourselves in permanent lockdown to protect us from a wave of diseases that we cannot treat.

Gupta: This goes back to what the role of an investor is. Fundamentally, it is to have that supportive dialogue and engender change. Don't start with an antagonistic tone. It has to be one of togetherness. It is about collaboration, it is about the long term, but showing where to go next if there is not that clarity of mind.

At a fundamental level, it is about understanding the other side of the table. Everybody is on the hamster wheel of business as usual. They have to deliver what is in front of them and we are asking them to think about these deep issues that are entrenched in society that no organisation has an answer for.

In a practical sense, there is only so much bandwidth even the senior leaders have. It is all about culture. How do the senior executives look away from business as usual and start looking at the next five years, the next 10 years. For example, the whole concept of anti-microbial resistance and biodiversity are not even on their radar. Their current challenge, a big one, is getting to net zero and that needs considerable, and yet non-negotiable, effort.

Gilshan: I have attended many AGMs and spent most of my in-house career working for smaller investors in terms of their assets under management, so it is about efficiency, how best to get a message out.

Making a statement at an AGM on diversity or executive pay is not only a signal to the individual company but also the marketplace, as you cannot cover every company.

Marks: On the point about getting your voice heard, we can do that just as well on the positive side. You can name and shame or name and fame.

Gilshan: We need to re-frame some of this. We talk about levers or tools, but some of them are shareholder rights. You have the right to attend an annual general meeting. Making a statement is not seeking publicity. It is saying: "I have engaged, or engagement is ongoing, but I would like to escalate that through attending an annual meeting." I wish investors would use these rights fully to make change.

Chapman: Voting against directors is a powerful and underused tool, rather than raising a shareholder resolution where the threshold for it to pass is higher. If you don't believe that the transition plan is ambitious enough, then the unitary board structure in the UK means that you can vote against the board.

Gupta: Why do companies feel that shareholder resolutions are against them? You are a shareholder; you have rights and are putting across your point of view. Why is it considered so negative? It should be used as a tool that investors have.

Chapman: We have talked about the futility of engagement, but we should celebrate situations where it has worked. Engagement is about persistence, it's not a one and done issue.

Microfiber plastics in the oceans is a significant problem, with one million metric tons entering the seas every year, affecting the feeding patterns and reproduction of marine organisms as well as human health.

Every time you wash your gym kit, 700,000 of these particles are discharged into wastewater. First Sentier Investors led an engagement with 30 other investors to engage 13 washing machine manufacturers. They also engaged with governments, with France passing legislation from January 2025 where new washing machines have to be fitted with filters that capture these fibers.

The coalition's other successes include convincing Grundy and Electrolux to produce machines that have these filters fitted as standard.

Bishop: This feels less controversial. Nobody disagrees with not putting plastics in the ocean, so it is easier to sign up to versus issues that feel more politically charged.

Marks: It is an interesting point because language matters. We were talking about the US. Right-wing politicians in the US may not find it controversial to talk about nature conservation, but if you say re-wilding...

We need to think about the language and the way we have the conversation. In our everyday conversations, we think about who you are talking to and how they will receive it. As investors, we need to bring that mindset: what outcome are we seeking? What's the approach we want to take? How will we understand the milestones along the way?

Gilshan: Sometimes a lot of the outcomes we look at are often through the lens of the company, such as CEO pay. We should look at these outcomes through the lens of beneficiaries and other stakeholders, such as employees and customers.

> **Effective stewardship should be demonstrated irrespective of how your capital is invested.**
>
> Claudia Chapman
> Head of stewardship, regulatory standards division
> Financial Reporting Council

> **The ability for owners to influence managers depends upon good transparency on their practices.**
>
> Simon Rawson,
> Director of corporate engagement & deputy chief executive
> ShareAction

Coal Pension Trustees outsources its engagement function. What do you look for in people to represent you?

Bishop: We use managers to engage with companies, but it doesn't mean we cannot engage with companies ourselves.

We see it as our role to engage with our asset managers. It is about efficiency. We can compare them and tell them that these are the areas you are doing well in, and these are the areas you are not.

We do not often engage with individual companies, although we have tried to support a few more resolutions, but we are resource constrained.

Chapman: Choosing managers who align with your investment objectives and philosophy and then checking that is being followed, that is your stewardship role.

Bishop: Then we escalate concerns within those relationships. We have withdrawn voting rights from managers and added voting rights to those we previously with-

> **If a significant body of investors are having the same conversation, their voice is amplified and is taken with a certain seriousness.**
>
> Shipra Gupta
> Investments stewardship lead
> Scottish Widows

drew them from. We have fired managers who are failing to take material risks or opportunities into account.

We have had conversations about what is good stewardship in Asia and now we are having conversations around what is good stewardship in the US. We set a bar; do we now have to lower it?

Gupta: We are having the same conversations. As an asset owner we engage ourselves in a limited way, either directly or through collective measures. A lot of this is about showing best practice, about monitoring our managers, challenging them on how they voted and showing them what others are doing.

Rawson: The ability for owners to influence managers depends upon good transparency on their practices. This comes back to stewardship reporting, where, while weak globally, the UK is leading the way.

Asset owners that have the conviction to then fire their managers are terrific. We have a number of asset owners in our collaborative initiatives and the influence they have in getting managers to back a resolution or sign a statement is tremendous.

Yet we also face cases where asset managers refuse to vote. It is when you hit those barriers and are not able to resolve them that you have to be prepared to move a mandate. That is the stewardship superpower asset owners have.

Gupta: Our role is to influence the market. If we can move a manager's vote, and therefore how all their clients' shares are voted, we have played a bigger role than just moving our votes. That is where the difference is. This market is fast evolving and there will be variations on how to make progress using shareholder rights.

Bishop: We have been having conversations around fixed income and asking: how is buying a new issuance different from voting? It is saying yes or no to a company's strategy every time it comes back to you.

You can do it below the radar in that it does not have the same level of scrutiny as voting. If your manager is finding it hard to vote against a company, perhaps they could refuse to buy the next debt issue unless changes are made. Fixed income feels more opaque than equities if they want to do the right thing.

Marks: Stewardship is across the capital structure. It's not equity ownership, it's asset ownership. When we engage, we engage with corporates on all aspects of their strategy. It is just as relevant, if not more so, when we are supplying primary capital via debt issuance than voting on secondary capital in the equity market.

Bishop: It is a decision you make more often. Equity managers invest for 10 years while they have to decide about debt every six months.

Gupta: In fixed income this is not used enough. Whenever we engage with our managers in this area, we rarely find examples of where the fixed income desk has led such stewardship. It is usually the equity and fixed income desks coming together to do it.

Bishop: We have met fixed income managers who have told us: "Stewardship doesn't apply in fixed income."

Gilshan: But it is also about optimising the points at which you have the most power. One of the most fascinating engagement meetings I ever had was with a US company. All the risks we were worried about came to fruition because of a combined chair and CEO. When they appointed an independent chair, we told him that our economic exposure was beyond our equities and he had a lightbulb moment. It is about not having these systems working in isolation but optimising the positions that we have.

Voting decisions are often binary. It is yes or no, for or against. How we capture the nuance of that decision is why I believe that vote reporting needs to improve and is why I am delighted to be leading the working group the Financial Conduct Authority has convened to look at that. We have all these rights, but it is about optimising them to the best of our ability for savers.

The Stewardship Code is under review, so what will it look like going forward?

Chapman: We are not overhauling it. It is fit for purpose following the 2020 review. What we will look at is clarifying, streamlining and raising expectations in some areas.

We want to focus on the role of systemic stewardship. Today we have talked about system change and the role of collaboration and what that means, especially if you are a universal owner.

We are also looking at a common language for stewardship. We see a wide interpretation of engagement in reporting and that makes it difficult to compare and assess the efforts of investors.

Rawson: What about focusing on outcomes?

Chapman: We have a focus on outcomes. We talked about attribution sometimes being difficult to achieve. There is a strong focus on this and perhaps we need to look at the quality of some of those outcomes.

Marks: When we start a stewardship engagement, we should always be thoughtful of the change we are seeking, why we are seeking that change and how we will know we are achieving change.

If you don't get the outcome that you were seeking, it does not necessarily mean that the engagement was not worthwhile.

Deborah, what do you think of the quality of stewardship reporting?

Christie: It is improving, but transparency is key and we are not always getting that.

I talk to boutique managers all the time, who tell me anecdotes in person, but they do not report on anything. Again, the US is further behind Europe. It has some requirements and is moving towards more, but it currently still is a mixed bag.

Gupta: We are not the police, but we are investigating in a measured way. For example, we are asking companies if deforestation has happened and if are they monitoring it.

Thankfully, there is now special data coming, which we have to see how reliable and credible it is, but it is hard when you are sitting through a desktop as companies come prepared with good anecdotal examples for meetings with investors.

It is hard. I don't know exactly what level of reporting will give us that level of disclosure, but advances are being made.

Rawson: What is the quality of the advice consultants provide asset owners? It is my impression that there is a lot more they could do to provide objective information about the quality of stewardship, particularly for some of the environmental and social outcomes.

Christie: I do not know what my peers are doing on a day-to-day basis, but I can tell you that we are actively engaging with all asset managers on behalf of our clients.

We have, particularly in the United States, huge initiatives behind diversity, equity and inclusion because we have clients who care about this topic. They have created escalation policies for their managers and want to know where they stand in terms of diverse ownership.

Clients are asking what their investment managers look like in terms of diversity today. Where do they want to be in five years? How are they going to get there? What's our manager's escalation policy? If the investment firm is made up of five white men who are managing this boutique, is that okay with us? What are they doing to change this and achieve a diversity of thought? What are their policies? Do they have a diversity, equity and inclusion policy? How often is this policy reviewed and updated? Who is involved in that process?

We are having these conversations with investment managers – then the client has to decide for how many years they are willing to have this conversation.

Bishop: Do you rate managers on stewardship and diversity?

Christie: Stewardship and diversity are aspects of how we evaluate managers. Some clients care about this, some don't.

First and foremost, we are looking for a high return for all of our clients, but their needs and unique goals have to be taken into consideration.

They not only want a return, but they might also look for more manager diversity or to be moving towards net zero.

Clients need to understand all of these issues, so we do the due diligence for them. We provide the information so clients can make the best decision for their specific, and unique needs.

Gilshan: One of the most powerful statements I have seen from an asset owner on diversity, equity and inclusion was a letter from the late David Swensen, who at the time was chief investment officer of the Yale Endowment Fund. He wrote to all of the fund's external managers to highlight the collective responsibility on diversity, equity and inclusion, in terms of making financial services and investment more diverse.

It was so insightful and demonstrative of the power of asset owners to use the levers they have to drive change. I applaud him for doing that.

Portfolios are changing because ownership is changing.

Deborah Gilshan
Adviser, investment stewardship & ESG
Founder of The 100% Club

PRIVATE MARKETS: ILLIQUID DREAMS

Illiquids offer the potential for better long-term outcomes but is updated regulation sufficient to accommodate change and how is the industry responding? *Gill Wadsworth* reports.

Defined contribution (DC) pension savers could have made an extra 2% last year if they had been invested in illiquid assets. Yet these sources of additional return rarely feature in the default strategies offered to members.

Consultancy Hymans Robertson's Master Trust Default Fund Review published in May found that historically, average returns from illiquid investment strategies "would have improved net returns for members by 1% to 2% per year over the last decade, assuming a well-diversified approach".

The findings provide well-timed fuel for the government's effort to drive more investment in long-term assets that support its levelling up agenda.

The government sees pension funds as critical in providing the billions of pounds in investment needed to bolster the UK's infrastructure, housing and green energy projects, yet the DC universe – set to be worth £1trn by the end of the decade – remains hamstrung by daily pricing requirements, cost constraints and governance burdens.

There has been significant reform to overcome these obstacles including relaxing the 0.75% charge cap imposed on workplace DC default funds, making it easier to include performance fees which are typically imposed by managers running illiquid asset strategies.

The charge cap reform preceded a decision by the Financial Conduct Authority this March to authorise the first Long-Term Asset Fund (LTAF), a move the regulator's executive director of supervision, policy and competition, Sarah Pritchard, said, "creates an environment where investors who wish to invest in productive finance assets can more easily do so".

Market innovation

Since then, Schroders, which was the first to launch an LTAF, has bought a second illiquid assets offering to market, alongside Aviva Investors' Real Estate LTAF which has been seeded with £1.5bn in assets from the company's life insurance business. Meanwhile, in May, Blackrock received approval for a diversified alternative strategies LTAF combining multiple private market asset classes, such as infrastructure, private credit, private equity and real estate. Duncan Hale, of private markets group Schroders Greencoat, which runs the asset manager's second LTAF focused on renewable energy and energy transition aligned infrastructure investments, says a more amenable regulatory environment for illiquid assets in DC has been a long time coming.

"For too long DC pension scheme members have had their noses pressed up against the glass, looking in at other types of investors enjoying the benefits that come from investing in illiquid assets. [LTAFs] could only be possible due to the regulatory progress made through the LTAF regime," Hale says.

The appetite for illiquids, at least from master trusts, is evidenced by Cushon's 15% allocation to private markets which is on offer through its sustainable investment strategy at a fund management charge of 0.15%.

Meanwhile, the £30bn National Employment Savings Trust (Nest) invests £5bn of DC savers' money in property, private credit, unlisted infrastructure and private equity, while Smart Pension has invested in illiquid assets since 2021.

Jesal Mistry, senior DC investment director at Legal & General Investment Management (LGIM), which only includes private market assets such as short-dated private credit in its default strategy for those who are closer to retirement, plans to extend illiquid investments to all members of its master trust.

"The natural next step is to broaden this out to the wider universe of private market opportunities throughout the entire journey within DC strategies, using the scale of the master trust structure to enable this," Mistry says. "It is critical that we continue to do everything we can to provide our members with the best possible outcomes. We believe private markets will play an increasingly central role in DC investment portfolios at all stages of the member journey, including in the L&G Master Trust."

Value over cost

However, wholesale moves by master trusts into illiquid assets is still hampered by a persistent focus on keeping costs low for auto-enrolled (AE) members.

The Pensions and Lifetime Saving Association (PLSA) describes the AE market as "relatively immature and highly competitive. It has consolidated rapidly and continues to do so. In a fierce market small points of price difference make a significant impact".

This is particularly true in the master trust sector, where some providers still use fee differentiation – rather than focusing on value – to capture market share.

Mistry says: "In the past, the focus was all about driving down cost for schemes, which is an important consideration but did limit innovation in the DC market – this led to an emphasis on low-cost index funds in DC investment strategies."

It is fair to say that illiquids require greater hands-on governance from a board of trustees.

Jesal Mistry, Legal & General Investment Management

Mistry adds that there has "been a real shift in terms of the regulatory agenda" noting that the government's Value for Money consultation which closed in March, was "all about focusing more holistically on how we define value through net of fee performance".

"This shift will also need to happen across the market, and it is vital that value is judged more holistically to allow for any meaningful allocation to illiquids in DC strategies," he says.

Callum Stewart, head of DC investment at Hymans Robertson, calls on master trusts to re-evaluate their ability to include illiquid assets now, or risk regretting it later.

"Fast forward a decade. Would you be more comfortable having a conversation with a member about how their pension savings have been invested at low cost, or that you have delivered a superior net return regardless of the cost required to get there?" he says.

Significant hurdles

Looking further across the DC landscape, particularly to smaller schemes, the challenges of including illiquid assets becomes more acute.

What some in the industry call an "obsession" with daily pricing, which allows investors to transfer in and out of funds at will using up-to-date valuations for those assets, has turned them off illiquid assets.

But the Institute and Faculty of Actuaries says: "The vast majority of DC investors do not require daily trading, staying invested for the long term with very limited trading activity throughout their membership."

Meanwhile new contributions coming into the scheme enable them to buy-out the units of older members.

But Sam Burden, client director at independent trustee firm Zedra, says this requires scale.

"I am a proponent of investing in illiquid assets if you can get over the practical challenges, and there are a lot of hurdles to overcome. If you invest in illiquid assets you will need scale to ensure you can still meet daily trading requirements.

"At the moment it seems the master trusts are the only ones with the scale to look at this," he adds.

And despite the advent of LTAFs, the PLSA says typical fund structures and fee models "do not accommodate DC schemes' needs well for illiquid investing", noting that scale in DC is delivered through platforms but these "currently offer limited choice, if any, which means these are only accessible to the much larger schemes currently slowing down take-up".

Joe Dabrowski, deputy director of policy at the PLSA, says: "LTAFs are fairly new, and it takes a while for trustees to have a look at what's available and make a decision about investing. We are beginning to see some of that come through the system now and more will probably come through during the year, but it's not going to be a big bang change."

The PLSA says that while some platforms can accommodate investment in illiquid assets, others still need to evolve their systems and processes to be able to do so. Some structures also face restrictions under the permitted links rules for unit-linked life policies.

This means more platforms evolving their systems and processes. Heather Brown, senior client solutions director at Aviva Investors, says: "I haven't seen much movement from platforms on illiquid assets and I've been hearing that some are maybe better than others. But this could change quickly."

The PLSA says it is "essential to establish a rich, and continuous pipeline of enterprises needing investment for providers to bring to market and investors to choose from."

At the moment it seems the master trusts are the only ones with the scale to look at this.

Sam Burden, Zedra

The association calls on the asset management industry to focus on sourcing UK opportunities and developing new investment funds and products which are appropriate to pension fund needs.

Governance burden

Given that members bear the investment risk and typically incur the fees in a DC scheme, making sure they are on board with illiquid investments is important, and that responsibility falls to trustees.

The challenge, according to Brown, is convincing them that illiquid assets will live up to outperformance expectations over cheaper passive equity strategies.

"Passive equities had a good run over the last 15 years, and they have served members well. When making the case for illiquid assets in DC, the challenge we hear is 'where's the evidence that we would be better off?'. There's no crystal ball gazing," Brown says.

This is compounded by the additional governance burden of investing in illiquid assets.

"It is fair to say that illiquids require greater hands-on governance from a board of trustees," Mistry says. "The trustees need to understand the underlying investments the scheme has exposure to, as well as the issues around liquidity and how these can be resolved.

"Asset managers" Mistry adds "have a key role to play" helping schemes understand the issues around their cashflow and investment objectives, and then providing the right blend of assets which can combine ready sources of liquidity with long-term, sustainable growth.

But so too do investment consultants not only in the education piece, but in ensuring schemes are aware of the available products, and Brown suggests provision of the latter is somewhat patchy.

"A lot of [investment consultants] have come out over the last 12 months as fully supportive of the [illiquid asset] regime and structure. But what's interesting is where they are in terms of their manager research process, because as much as they might be talking to schemes, unless they have actually done that research, then they are not in a position to recommend any funds to schemes. I think that progress is quite different across the consultant universe," she says.

Irrespective of the theoretical benefits from including illiquid assets in DC schemes, the practical realties of doing so remain profound. Considerable advances have been made in terms of regulatory reform and product innovation, but the journey is far from over.

A concerted and combined effort from policymakers, asset managers, platforms, investment consultants, master trusts and trustees is needed if members are ever to realise the long-term potential illiquid assets can offer.

THE FINAL COUNTDOWN

22%

...of private equity and venture capital firms expect fundraising to increase this year, down from 72% in 2022. Supply-chain constraints, inflation and the war in Ukraine have been blamed for such a fall in confidence.

Source: Acuity Knowledge Partners

£67bn

The aggregate surplus among FTSE100 defined benefit pension schemes at the end of 2022, up from £59bn a year earlier. The average funding level increased to 120% from 110% during the period.

Source: Lane Clark & Peacock

0.4%

The expected growth of the British economy this year, upgraded from -0.4%, before climbing to 1.8% in 2024.

Source: CBI

€7.7bn

The estimated net inflows for European ETFs during May.

Source: Refinitiv Lipper

50%

...of asset managers expect their insurance clients' exposure to digital assets will be between 2% and 5% during the next three years, while 43% expect it to be between 5% and 10%..

Source: Nomura

52%

The level of intermediaries expecting to increase their allocation to fixed income this year.

Source: Capital Group

3.8%

The estimated real GDP growth in emerging markets in 2024, compared to 0.5% in developed markets.

Source: Amundi Asset Management

36%

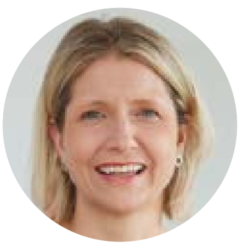
...of alternative fund managers expect inflows from pension schemes to increase "dramatically" in the next 18 months.

Source: Ocorian

$10.4bn

The estimated investment in emerging market securities during May, slightly up from the $9.8bn estimate for April.

Source: Institute of International Finance



Quote of the Month

"Effective stewardship should be demonstrated irrespective of how your capital is invested."

Claudia Chapman, Financial Reporting Council