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Events

ASIA: EASTERN PROMISES

More people in Europe have celebrated their 65th birthday than ever before, while its hospitals are delivering fewer babies. Add in that its economies are generating little growth, if any at all, and the investment case for the region has looked better.

The outlook for the US is more attractive. The country is home to the tech stocks that excite consumers and investors alike, while the IMF expects the economy to expand by 1.6% this year. However, this is down from the 2.1% recorded in 2022 and is around a quarter of India's projected growth this year.

The West's status as the world's economic engine room appears to have ended with most of the globe's growth set to be generated by the East in the coming years, fuelled by a younger workforce.

This month's cover story discusses if long-term investors should look to the East as a primary source of growth and income. From page 16, you can read our take on why China, India, Taiwan, Singapore and South Korea could one day be institutional investors' largest exposures, if they are not already.

Stable and recuring income is needed now more than ever considering that we are living through a time of low growth and high inflation. Infrastructure is an asset class which could offer that, so why are allocations lower than expected? We take a look from page 46.

Elsewhere, private credit has emerged as an institutional asset class thanks to banks withdrawing from certain markets. Our coverage on what investors need to know starts on page 20.

Also emerging in importance for the British pensions market is defined contribution. We brought trustees, consultants and an asset manager together to discuss investment strategy following such a challenging 2022. Read what they had to say from page 34.

Investing is not just about closing the deal. Engagement to improve a corporate's operations, especially on issues of sustainability, is now a big part of the process. Tackling inequality is one such issue, which includes deciding how much an executive is paid. We put the issue under the microscope from page 30.

Finally, Joe McDonnell, the new chief investment officer of Border to Coast, explains why he wants to work with people who see the world differently, while Mahesh Roy at the Institutional Investors Group on Climate Change discusses some of his concerns about the fight to protect our planet.

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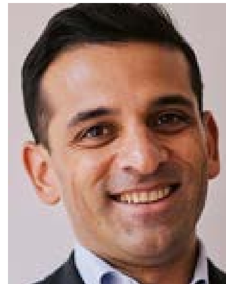

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LGPS CENTRAL GOES BIG ON PRIVATE CREDIT

The pensions pool reveals why private credit is central to its investment approach. *Andrew Holt* reports.

Institutional investors should be looking at private credit for diversification and stable returns, according to one of the UK's pension pools.

Mike Gillespie, investment director, private credit at LGPS Central, told *portfolio institutional*: "Private credit is a proper diversifier. If you look at the asset class it is not correlated to public markets. There are good yields, opportunities and inflation protection through floating rate loans as well."

The pool is putting its money where its conviction is, with LGPS Central confirming its LGPS Central Credit Partnership has made its seventh commitment of €125m (£107m) to PCP Corporate Credit Fund V.

"PCP's unique value proposition, bolstered by a successful track record, has captivated investors seeking diversification and stable returns. And this is a good opportunity for non-sponsored deal lending to diversify," Gillespie said.

Strong commitment

Gillespie revealed the pool has a large exposure to the asset class. "We have commitments with our partner funds of £2.5bn. We have all strategies.

"The first is the lower return sleeve, which is direct lending. Next is real asset, which is a blend of infrastructure debt and real estate. Third, we have index-linked investment grade infrastructure debt in the UK. And finally we have a higher return sleeve, effectively a credit opportunities fund."

LGPS Central normally goes for diversification by sector – healthcare, industrials, IT and the like. "What we don't typically have is diversification by product type," Gillespie said. "So when you see markets that are slow, we think it's a good idea to invest in managers who specialise in 'non-sponsored assets as these typically generate higher returns using lower leverage and better controls in our portfolio."

This investment represents the final commitment for the LGPS Central's Credit Partnership II, with more than £1.1bn committed across seven managers. "PCP specialises in non-sponsored lending and targets mature businesses with stable cashflows in the middle market," Gillespie said.

Headquartered in Stockholm, the firm has a broad focus in Northern Europe, primarily in the difficult-to-access Nordics.

Actively managed

Gillespie said the firm has a good track record in European private credit having completed debt investments for more than two decades, representing €4.5bn (£3.86bn) of invested capital and generating an overall return of 10.8% during that period.

PCP actively manages its investments by undertaking detailed monitoring and, where appropriate, seeking board observer seats. By targeting the lower to core middle market and preferring to lead or co-lead investments, PCP maintains optimal control and influence over its portfolio.

The regional factor is a key attraction for LGPS Central, with a focus on non-sponsored deals in the Nordic and DACH (Germany, Austria and Switzerland) regions.

"They are hard to break into," Gillespie said. "When we talk about direct lending, we mainly mean UK and northern European countries. It is difficult to break into Scandinavia and the wider Nordic markets as they tend to do things in-house."

There is no doubt that private credit has emerged as one of the most attractive asset classes, garnering attention from prominent institutional investors and amassing nearly $1.5trn (£1.19trn) in assets. This growth has been rapid in recent years. For example, six of the largest alternative managers have roughly doubled their assets under management devoted to private credit since 2019.

Major player

In this way, private credit has transitioned from being an investment niche to a central player in the financial sector. It is not difficult to see why.

Private credit can offer investors higher yields, increased negotiating power, and favorable business cycle conditions, which are drawing in more and more investors, as the numbers suggest.

In this scenario, private credit has filled a void. "This year has seen continued high demand for private credit solutions as other sources of finance have become more scarce," said Matt Douglass, senior managing director and head of PGIM Private Capital.

A point shared by Jo Waldron, head of client and solutions, private credit at M&G, who highlights the range of private credit on offer. "Private markets are made up of a series of different asset classes with different risk and return points. Assets range from investment-grade private placements to the more esoteric often sub-investment grade asset classes, such as direct lending. Every client's risk-return profile is unique – private credit offers a credible option to achieving those goals via diversified stable cashflows," she said.

But the rapid escalation of the asset class has resulted in questions being raised about the potential risks involved.

Gillespie accepts that risks do come with private credit. "It is not risk free. We are currently experiencing double-digit yields in this interest rate environment. With that, comes high risk. The biggest risk is that of default. The other is risk liquidity. Private credit is long-term. There are no gated exits," he said.

Read more on private credit from page 20.

CHINA CRISIS? WHAT CHINA CRISIS?

Recent developments in the world's second largest economy present a worrying picture, but, as *Andrew Holt* discovers, investors should not get too worried.

Is China in crisis? To read much of the coverage of China and the challenges within its property sector along with the suspension of its bond trading, it would seem to suggest the country is looking into the abyss.

There is no doubt that the property sector, which accounts for a whopping 25% of China's economy, has finally come crashing down, the result of which could potentially linger for years.

"This was the predictable consequence of over-indebtedness and overbuilding combined with worsening demographics which curtails household formation and reduces the number of first time buyers," noted China expert George Magnus in one of his commentaries.

Mike Henry, chief executive of miner BHP, said that property completions in China are up 19%, year-on-year. What is proving slow, he added, are new starts. Creating something of a vacuum.

Refinitiv data reveals an investment trend that could be worrying: China-focused mutual funds suffered a net outflow of $674m (£533m) in the second quarter of this year, while, in contrast, nearly $1bn (£795m) went into emerging market ex-China mutual funds.

Deflationary threat

This is just one of many fronts in which China faces challenges.

An equally worrying trend is the fact that policymakers in Beijing face a potentially bigger and different challenge – that of deflation.

China reported a 0.3% year-on-year decline in headline CPI for July, entering deflation for the first time in two years. The headline weakness was exacerbated by temporary factors, such as lower energy and pork prices.

"Deflation punishes debtors, of which China has many, and is often a companion of economic stagnation. In China, this could have catastrophic geopolitical consequences," Magnus added.

Indeed, given China's strength in the global economy, what happens in the country has huge ramifications across the globe.

There are winners though from even this scenario that investors can plug into.

There are, according to Rob Brewis, a fund manger at Aubrey Capital Management, "clear disinflationary winners". These are, he noted, the global cost leaders with strong balance sheets and strong cashflow.

Another perspective, at least for more long-term investors, is one in which there is no reason to panic. China remains a leader in clean technologies, electric vehicles and other science and tech sectors.

Growth engine

China is still a key engine of global growth. The International Monetary Fund estimates that the country will account for more than a third of the world's economic growth this year.

In addition, many analysts agree that China's 5% GDP growth target for this year is well on track – hardly an indication of a crisis.

Furthermore, JP Morgan Asset Management has noted that Chinese stock valuations look to be capped by geopolitics, but traditional measures are at historically attractive levels with a "likely upside" once earnings begin to surprise positively.

That moves away from a crisis scenario – or rather, presents investor opportunities that exist amid all the talk of a crisis.

Indeed, the gap between US and Chinese equity valuations is the widest since March last year, and one of the widest in more than 20 years.

According to MSCI, US stocks are trading at 19.8 times 12-month forward earnings, almost twice China's 10 times multiple. And that gap of almost 10 points has doubled in the past year.

China's blue chip equity index is down around 1%, year-to-date, while the S&P500 and Nasdaq are up 18% and 35%, respectively.

Such a scenario suggests some rebalancing is overdue.

Fidelity has said that for MSCI China, it is looking at "probably earnings growing in the high teens" this year. In comparison, forecasts for the US are closer to flat.

Long-term trend

Here long-term investors should not lose sight of trends that go out over the next decade and beyond.

To emphasise this, Goldman Sachs has issued a study projecting that, by 2035, emerging markets' equity valuations will overtake those of the US, which currently has 42% of stock capitalisation, compared with 27% for the devloping world.

Come 2035, emerging markets and the US will have 35%, but emerging markets will have a smidgen more.

By 2050, the developing world, will command 47% of world's market cap to the US' 27%, and by 2075, emerging market stocks will reach 55%, while those in the US will fall to 22%.

A key point made by Goldman Sachs' economists Kevin Daly and Tadas Gedminas is that by 2050, China is on target to be the top economy, with the US, India, Indonesia and Germany trailing behind.

Such insight puts China's current difficulties into perspective.

Read more on the outlook of China from page 16.

PEOPLE MOVES

Nest is searching for a new chief executive after **Helen Dean** decided to stand down from Britian's largest master trust after eight years. Whoever replaces her will be leading an organisation which has £26.8bn of assets under management.

Jon Little is the new chair of **Local Pensions Partnership Investments**.

He brought two decades of asset management experience to the pool when he replaced Sally Bridgeland in August.

Little is the founder and managing partner of Alderwood Partners, an asset management advisory firm, and established Northill Capital.

Little is the non-executive chair of the Oxford Brookes University Endowment's investment committee. He has also been chief executive of BNY Mellon's international asset management business and chair of US mutual fund manager Dreyfus and of asset manager Insight. Little has also worked for Fidelity, JP Morgan, Jupiter Fund Management and Quilter.

Workplace pension scheme provider **TPT Retirement Solutions** has appointed

Georgie Edwards as head of defined contribution.

Edwards (*pictured*) will develop a DC product that will make the transition from accumulation to decumulation easier.

She joins the scheme, which has 425,000 members, from Fidelity International, where her responsibilities included fostering DC sponsor and trustee relationships. Before that, Edwards was a DC consultant for Lane Clark & Peacock and PwC.

People's Partnership, which provides The People's Pension, has strengthened its board through the appointment of **Laura Chappell** as a non-executive director.

Chappell (*pictured*) is chief executive of Brunel Pension Partnership and has more than 30 years of asset management experience.

Best Trustees has selected **Tim Allison** as its newest professional trustee. He joined the firm in July having worked with multiple defined benefit schemes, being a trustee and investment committee chair for Smith & Nephew's UK pension scheme.

CALENDAR

Themes for upcoming *portfolio institutional* events:

September
– ESG Club Conference 2023

September
– Defined Contribution Roundtable

October
– Fixed Income Roundtable

November
– DC Investing Roundtable

November
– Sustainable Strategies Roundtable

December
– Real Estate Roundtable

Finally, **The Pensions Regulator** has re-appointed Katie Kapernaros and Chris Morson as non-executive directors. They will continue in their roles for another four years starting from April 2024.

Morson will also continue to chair the regulator's audit, risk and assurance committee.

NOTICEBOARD

Railpen, which manages £34bn of retirement assets for Britain's railway workers, has awarded a £2bn liquid multi-asset credit mandate to Neuberger Berman.

The mandate will cover investment grade and non-investment grade assets. The strategy sits within Railpen's Growth Fund, a multi-asset portfolio.

Phoenix Group, a retirement business with £259bn under administration, has provided £58m of debt to a joint venture between Bromley Council and Pinnacle to fund more than 200 affordable homes.

The 55-year inflation-linked loan and will enable London's largest borough to increase its stock of affordable housing. The properties have been earmarked to house the homeless or those in temporary accommodation.

Defined benefit pension scheme insurer **Pension Insurance Corporation** has lent £38m to freight and railcar leasing company **Streem** to help decarbonise its operations, which total more than 46,000 railcars and 80,000 containers.

Student housing developer and landlord **Unite** has refinanced a £400m bond thanks to **Legal & General Investment Management**. The firm's UK and European real estate debt division refinanced the maturing loan, which was secured against 23 purpose-built student accommodation properties across the UK.

The **BT Pension Scheme**, which has £47bn of assets under management, has agreed a £5bn deal that will protect it against one of its biggest risks – longevity.

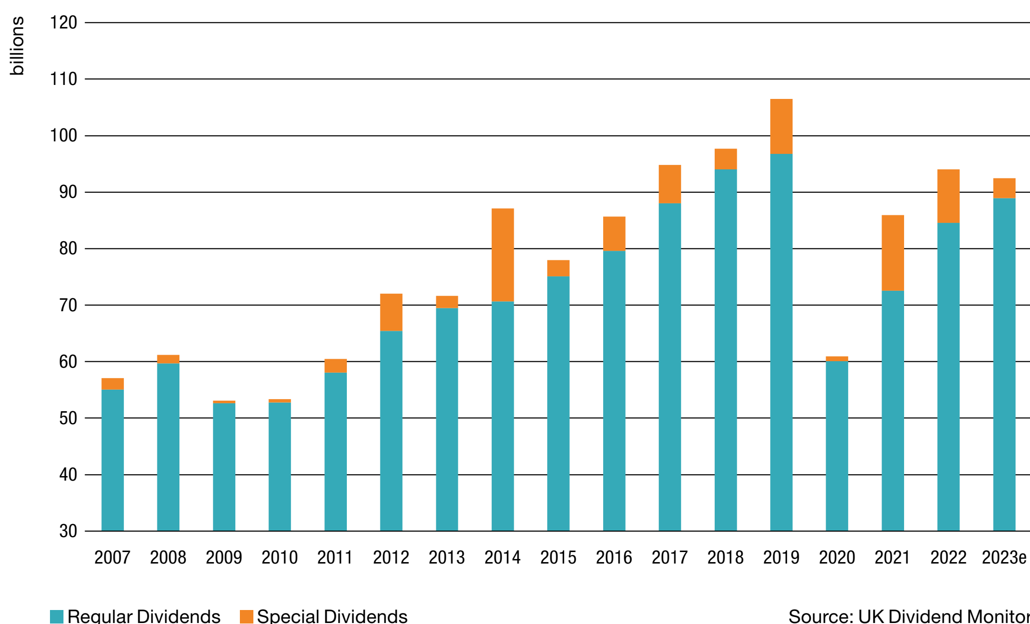
The longevity insurance and reinsurance arrangement with **Reinsurance Group of America** covers the scheme against its 270,000 members living longer than expected.

It follows the £16bn of BT's liabilities covered by a similar arrangement in 2014.

Legal & General has completed a £1.8bn buy-in with the trustees of two pension schemes sponsored by water company **United Utilities**. The transaction provides the schemes with secure income that covers around two-thirds of their liabilities.

Finally, **Canada Life** has agreed a £24m full buy-in of the pension scheme for workers at restaurant chain **Roadchef**. The deal covers the benefits of 547 pensioners and deferred members of the Roadchef Retirement Benefits Scheme.

THE BIG PICTURE: BANKING ON GOOD DIVIDENDS



Dividends are set to beat expectations in 2023 by some distance, finds *Andrew Holt*.

There is good and bad news for investors on the dividend outlook. The bad news is that UK cash returns fell 9% on a headline basis to £32.8bn in the second quarter.

The good news – albeit relative – is that regular dividends tell us more about the true trend: and they beat forecasts in the second quarter at £32.2bn.

The underlying growth rate, which adjusts regular dividends for exchange rate movements, was 3.5% in the second quarter, down from 5.2% in the previous three months.

By far the biggest contribution came from banks, which have reported strong profits. They paid £7.8bn, an impressive three-fifths rise year-on-year. Banks are also comfortably 2023's biggest engine of UK payout growth, according to the UK Dividend Monitor.

Meanwhile, the broadly based industrial goods and support services sector delivered a double-digit dividend growth surprise in the second quarter: with 95% of companies in the sector recommending annual increases.

The biggest negative impact came from sharply lower mining payouts. These fell by a third, as lower commodity prices saw an impact on cashflows in the sector. And while economists ponder the potential deterioration of the British economy, with assessments edging towards a recession, the paradox is that the dividend picture has brightened.

The banking sector in particular is benefiting from the interest-rate medicine the Bank of England is administering to cool the inflationary fever.

Outside of the banking sector, companies with pricing power are building margins, contributing to inflation, of course, but in turn, boosting their dividend fire power.

For the rest of 2023, the third quarter is already playing out in line with Dividend Monitor expectations earlier in the year, but the fourth quarter now in fact looks likely to be markedly stronger.

Headline payouts are still likely to fall this year, down 1.7% to £92.4bn, as lower one-off special dividends and negative exchange-rate effects in the third and fourth quarters take their toll. But this is nevertheless £1bn more than was forecast three months ago.

Regular payouts that exclude specials are now on track to reach £88.9bn, almost £2.7bn more than forecast three months ago, and equivalent to an encouraging underlying increase of 6.1% for the year.

Daniela Silcock is head of policy research at the Pensions Policy Institute (PPI).

HOW EASY WILL IT BE TO COMPLY WITH NEW INVESTMENT PERFORMANCE REPORTING REQUIREMENTS?

The government and regulator intend to implement a pensions Value for Money (VFM) framework, designed to ensure that members receive better financial outcomes. Investment is part of it; requiring providers to disclose asset allocation and investment performance metrics.

While there has been a mixed reception from industry on the methodology underlying the reporting of investment performance, there is general support for the aims of the VFM framework, to shift focus from cost to value. But how easy will moves towards the disclosure of investment performance be for DC schemes considering the complications involving data and scheme size?

Data issues have plagued the pensions industry, with pushes towards greater transparency underlying a general dissatisfaction with the data schemes' produce. The VFM framework requires schemes to provide comparable investment metrics to highlight poorly and positively performing schemes. However, it is worth delving into the infrastructure within and surrounding schemes to understand how likely it is that valuable data will be forthcoming in a speedy manner.

Pension scheme management and reporting of data is personalised and schemes are not required to produce consistent data that can be easily compared. As a result, the government and the regulator will, over time, set stricter rules about how data must be reported. While stricter regulations on data will assist comparisons, they will also require schemes to invest in changing their internal processes.

Looking at other developments occurring alongside the VFM framework – the pensions dashboard and automatic consolidators for small pots – it appears that more uniform data reporting will be increasingly necessary for schemes to allow participation in national arrangements. This leads me to ask whether a process of requiring increasing levels of uniform data over time, which will require periodic adjustment, is the most practical approach.

Alternatively, a larger exercise undertaken jointly by industry and government aimed at developing uniform data collection and reporting standards could ease the path for schemes to participate wholly in VFM framework reporting. This approach may appear unattractive to the government and regulators as it will require time and resource and could delay the implementation of some ongoing projects. However, Australia adopted this approach and as a result can easily and cheaply transfer pots and compare scheme performance.

Alongside potential issues around data, some schemes may be concerned about appearing unfavourably on a comparison of asset allocation and returns. The UK DC market is a mix of schemes, with some still growing, as automatic enrolment was only introduced in 2012. This means that there are schemes which are growing in membership and assets under management that will be in a better position to undertake more complex and resource-intensive investments in a few years. These schemes may compare unfavourably to their larger peers, though within a few years they may have similar offerings. Those reviewing the data may not have a sufficient understanding to take the impact of policies on previous scheme performance into account.

Underlying the production of comparative data are questions about the end user. Employers choose schemes on behalf of their employees, which means that most pension scheme members have little choice about which scheme they are in. Therefore, the beneficiary of scheme behaviour, the member, is unlikely to benefit from the provision of comparisons, unless their employer uses them and chooses, or changes, their scheme as a result. Within automatic enrolment so far, scheme choice for many, especially smaller employers, has been based on ease and cost. It may require a further step, involving education with employers and/or employees about how to use and act on comparisons.

The VFM framework is a positive step in ensuring schemes focus on value and is likely to form an infrastructure which will help schemes provide better outcomes. But questions lie in how best to help schemes bridge the gap between where they are and where they would like to be.

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A TALE OF TWO REGIONS

For many years after the global financial crisis, markets were overhauled worldwide, but arguably the most existential waves of new rules for alternative asset managers rippled across Europe, creating new guardrails and checks and balances against the excessive risk-taking of the type that led to the crash.

Today, however, the pendulum has decisively swung back across the Atlantic. As regulators in the UK and Europe are trying to balance rulemaking with avoiding overly burdensome requirements, the Securities and Exchange Commission (SEC) has mounted a radical campaign for greater oversight and prescriptive control in lieu of taking a more principles-based approach.

Since 4Q 2021, the SEC has released dozens of proposals, some of which represent an alarming overreach in the supervision of the asset management industry and its ecosystem of service providers.

In addition to proposals to change the US market structure, the SEC has proposed two bundles of rule changes that mark a sea change for advisers and the fund management industry.

Private fund adviser rules

The proposal to adopt and amend certain rules applicable to advisers of private funds will alter the longstanding, widely used business arrangements of private funds. The most egregious features include restricting fee structures. The proposal also offers no grandfathering for existing contracts, which would require a costly re-papering exercise by the industry. It would also alter the liability standard for advisers, which may lead to some no longer offering certain strategies.

Securities dealer proposal

The SEC has proposed relatively low determining thresholds, which if met would mean that an investment adviser or fund would need to be registered as a securities dealer even though they do not engage in traditional dealing activities.

This could significantly impact the trading and investment strategies, operations, risk management, compliance and reporting functions of AIMA members. It also risks damaging US treasury market liquidity by discouraging bond trading.

The UK

Away from the tense mood in the US, the UK's regulatory environment is enjoying a renaissance. The broad package of rule changes – known as the Edinburgh Reforms – was announced late last year and promised to "drive growth and competitiveness in the financial services sector".

The Chancellor of the Exchequer used his annual Mansion House speech to unveil a swath of more detailed proposals for amendments to the rules governing UK's investment industry.

The main three changes related to the alternative investment industry bring welcome reforms to short-selling rules, the re-bundling of payment for research and securitisation. For short selling, the government will replace the public disclosure regime based on individual net short positions with an aggregated net short position disclosure regime. It will also double the threshold for net short position reporting to 0.2% of issued share capital.

For research payments, managers will once again be allowed to buy research on a bundled basis.

This is encouraging given our efforts to encourage authorities on both sides of the Atlantic to come up with a workable solution to the clash of their respective rules on research payment.

Finally, the UK is changing the securitisation framework by narrowing the institutional investor definition to exclude non-UK AIFMs, removing any uncertainty.

In summary

The trajectories of regulation in the UK and the US are, for now, clear, and juxtaposed. Whether the comparison of the alternative investment markets in these two jurisdictions – with one thriving and another being stifled – will give the powers that be in the US pause for thought is yet to be seen, but it's unlikely that the pendulum of regulatory scrutiny will swing away any time soon.

The only certainty is that the regulatory landscape is likely to remain highly liquid and AIMA in its role as a leading voice for the industry will remain vigilant in order to help our members and the wider industry navigate these changes successfully.

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INTERVIEW – JOE MCDONNELL

"We have been successful over the past five years, but we need to be constantly on our toes."

In his first interview as Border to Coast's chief investment officer, Joe McDonnell tells *Andrew Holt* about the attractions of joining the pool, why non-consensus thinkers offer so much and the challenges of the next five years.

How would you sum up your first eight months at Border to Coast?

It's been great. I knew some of the Border to Coast team, and several of its partner funds, before I came here, which helped. I've enjoyed the energy of the place and the commitment of its people.

Border to Coast has come a long way since it was launched five years ago and is a well-resourced pool, able to provide a broad suite of capabilities through our in-house team and external managers.

In my first few months here, I've been focused on getting to understand and know the investment team, as well as our partner funds.

What have you learned about how Border to Coast operates since you arrived?

A key part of my coming here was the recognition that Border to Coast has long-term backing from its partner funds and is already managing significant assets across key asset classes – I have always philosophically believed that you need to be in close proximity to the markets to be an effective investor.

As an investor, the team benefits from combining bottom-up insights with top-down macro thinking and more strategic thinking on secular trends, and what this means for our partner funds.

We certainly benefit from a combination of the insights you get from being a direct investor with the engagement you get with some of the best managers in the world.

Why did that model interest you?

Given the evolution of the corporate DB market, it's increasingly rare to find institutional investors in the UK who have expanding growth engines with significant allocations across public and private markets. That, along with a commitment to active management, internal and external, is the best combination in terms of managing money and, for me, is an incredibly exciting opportunity.

I believe this framework gives the LGPS a long-term competitive advantage over other institutional investors and wanted to play a part in it.

Looking at other investment models, are there any lessons from the LDI crisis last year?

It's a useful reminder that leverage is leverage, regardless of how some try to pack-

age it. While there were some short-term opportunities that arose, the LGPS is a long-term investor and so isn't directly focused on large scale hedging dynamics.

What are the organisation's biggest challenges?

Border to Coast has just turned five and it's incredible what's been achieved in this time. From an investment perspective, we are thinking about how we evolve our investment team and our broader capabilities. There are now about 140 people in the business – around 40 of which have joined in the past 12 months. We are combining the experience of veteran LGPS internal portfolio managers with those from the private sector. A key issue for me is to blend these individuals, with the right culture and approach to collaboration, and ensure we continue to provide good idea generation and challenge the portfolio construction process, implement that well and ultimately meet the expectations of our partner funds.

So continuing that culture and growth is one of your biggest priorities?

The priorities of our partner funds are simple: we are an active investor with 14 investment propositions across public and private markets. Our priority is to beat the relevant indices and to provide our partner funds with the support they need in delivering their investment strategies. We have been successful over the past five years, but we need to be constantly on our toes.

As part of our development, we've been working on how to challenge our own ways of thinking. This is through the evolution of our research team: expanding out from single stock to multi asset, as well as thinking about alternative research. However, we also do this by inviting a range of non-consensus thinkers who will interact with us and challenge our thinking. That is something I have encouraged over the past six months. It is healthy for portfolio managers to have conviction, go home and come in the next day and start questioning their thesis for a position. To help that process we want access to people in the market with interesting insights and with a different picture of the world.

What do the non-consensus thinkers come up with?
Going into this year everyone was expecting to have a challenging time. Volatility may be higher and earnings will gradually fall, but things did not turn out that way. Obviously, some non-consensus thinking was good for us and I am happy to see that, year-to-date, our public market fund strategies continue to be ahead of their benchmarks.
We are also engaging more on longer-term secular themes. This month we had a great call with a large UK asset manager, who talked about integration of artificial intelligence (AI) in their research process.
It is important for us on the investment and infrastructure sides of the business to get to grips with some of the technology that is coming through as this is happening at a rapid rate. I don't know if AI is going to be any bigger than the dotcom period from 20 years ago, but it could be material. Getting to grips with that is important.

Have you shifted your portfolio as a result of these thinkers?
We have updated our research and have moved to a global sector model. Before we had an individual regional approach, such as Europe and US, but now it is a more formalised global sector approach. Given the pace of change and complexity we are seeing in the technology sector alone, this is important. We now have experts who are deeper in this space and are not just reacting to it, and I want to see our private equity PMs interacting with our equity researchers on key themes.
To be clear, Border to Coast was functioning very well before I arrived. But this is about ensuring the investment team comes together more to debate topics from different angles.

You have highlighted how you are exceeding the original ambitions for pooling, having pooled 83% of your 11 partner funds' assets. What's next?
The main reason we have reached 83% is that we didn't launch a fund and then market it. From day one, we have worked to understand the collective needs of our partner funds and develop the propositions on their behalf.
Real estate is the last large scale asset class for pooling which we are focused on this year and next. As chief investment officer, I am not here to expand the assets, I'm not obsessed with getting to 100% – it's about getting the best performance on those assets we manage today.

If you will never get to 100%, what do you make of Jeremy Hunt's requirement for LGPS funds to pool all of their assets by 2025?
There can be practical reasons why you can't pool 100% of the assets – legacy private markets and micro-local investing are examples. We are focused on how we manage the assets as well as possible.
What I would say though, is that pooling is delivering real value for our partner funds – no individual UK pension fund could match the scale and scope of what we are able to do. In coming together, our partner funds have highlighted the benefits of a collective approach.

But can you understand why some funds earlier this year wanted to leave their pool?
I'm not going to talk about what has happened elsewhere – our philosophy is built on a common purpose and that has worked out pretty well.

Border to Coast's annual report revealed that collective net savings are on track to reach £340m by 2030 – how are you achieving this?
This is a standard methodology from the Department for Levelling Up, Housing and Communities that all funds need to complete. A large part of our savings are driven through our private market programme, which is currently £12bn.
As the years progress, the savings will increase as we expand new propositions. Cost management is important but over time we would prefer to focus on generating good excess returns will have a more material impact for pension funds, and the wider value we deliver – whether through our collective voice or helping our partner funds in areas such as the journey to net zero.

Why are you focusing on private markets?
It is important that we have significant growth engines. Structural diversification away from equities into private markets has been quite material over the past five to 10 years. This is a key element of our partner fund strategies and we have built a great in-house team to allow us to deliver it on their behalf.

What do you make of the government's desire to increase pension fund commitment in infrastructure and the leveling up agenda?
Investment strategy obviously remains the responsibility of our partner funds. That said, we already support them to invest in these areas, and we've just announced our UK Opportunities strategy. This will launch next year and will

Driving change in the real world is the best way to manage the risk of climate change, and engagement is fundamental to this.

include social property, infrastructure, social bonds, renewables and thinking about growth in private equity and private debt.

In our view, if you want to get a decent amount of assets invested in the UK, it is better to take a holistic view of putting capital to work – it's about diversification and reasonable return. We anticipate we'll end up working with around eight to 10 partners in targeting good returns but also capturing wider metrics – local employment, apprenticeships, residential units built, local infrastructure delivered, and so on.

What new investment approaches you are looking at and why?

For UK Opportunities, we want to make sure there are good regional opportunities – and we're not going into this with a fixed percentage regionally or in certain council boroughs. That is not the way to build a well balance portfolio.

We are going to work with a select group of specialist managers to consider all appropriate opportunities. Some will hopefully come through a bottom-up assessment approach, from our partner funds and elsewhere.

Social housing is an area we are looking to invest in. But we want to make sure there are good discernible metrics about how we are making a difference. In some cases that could be employment, in others it could be the green agenda and capturing those metrics.

We want to be open to idea generation from managers and look at things on a level playing field basis, with no structural bias to begin with.

The criticism is that there is frequently a lack of such opportunities to invest in.

There can be, but that is why a diversified approach is better. We will look for a strong economic return as our principal driver for investing. It will not make us feel good if we are investing in something that will not make us money just because it is a social good. It has to meet the investment returns required by our partner funds.

We want access to people in the market with interesting insights and with a different picture of the world.

You launched a new programme of engagement on the just transition: what does this involve and why is it important?

Just transition is the integration of the social dimension into climate strategies, including mitigating social risks.

For us, engagement is part of our investment approach, and it's about how you get the best investment returns from your portfolio. A just transition is good at making you think through the implications of the energy transition. So, for example, we want to make sure banks make the right decisions and understand any social impact or impact on their stakeholders. We work with a range of organisations on this, such as The Grantham Institute at the London School of Economics.

We are also focused on initiatives that we feel are important ESG themes. For example, we partner with Rathbones on modern slavery. There were 12 companies identified as failing on modern slavery. We have engaged on that, and they have adjusted their policies; this shows engagement works and can drive real change.

We have also been engaging with oil companies more directly. We tell them in advance that we will vote against them unless they instigate change. We have a well-resourced responsible investment team that is fully integrated into our investment process – and ESG and managing the risks and opportunities climate transition brings is fully embedded in that.

Data is an issue every investor cites as a problem within the ESG narrative, so how can that be addressed?

Data is a real challenge. The simple reality is that larger firms are better positioned with resources to provide data, but smaller cap firms aren't. This is something we need to change. I've seen initiatives where companies receive a discount on debt pricing if they provide more ESG data. But the simple truth is that all companies need to recognise that there is an upside for them if they engage.

So engagement is the best way to move the dial?

Yes. If you disinvest, you are out of the game. Why would a company listen to someone who doesn't own their stock? De-investment can create an initial big splash, but the splash dies away and you are no longer a factor for management – but you still remain exposed to the real world risks of climate change. For us, driving change in the real world is the best way to manage the risk of climate change, and engagement is fundamental to this.

What are you focused on going forward?

We've built the largest asset manager outside of London and Edinburgh, and we have an exciting future. My focus will continue to develop, support and evolve the team to ensure that, as a centre of investment expertise, we can support our partner funds.

ASIA

EASTERN PROMISES

"The West is the best, the West is the best," sang Jim Morrison on The Doors' 1967 track, The End. Few people at the time would have argued with him. Booming economies, lavish lists of investments and rising living standards all pointed to the West leaving the rest of the world behind. But that was a long time ago. Today, the modern equivalent can be found in the opposite side of the world. It is now time to look East.

The rise and rise of Asia has been powered by Taiwan, Singapore, South Korea and, of course, strongly carried forward by the growth of the population giants: China and India.

From here, the growth of Asia, it is said, will be led primarily by India. A point supported by the International Monetary Fund (IMF), which has seen enough to raise its 2023 growth forecast for the country to 6.1%. This boosts expectations that India will be the world's fastest growing economy this year.

The IMF says its upswing revision was guided by strong growth in last year's fourth quarter. This will only get better as the IMF sees India's economy expanding by 6.3% in 2024. This is at a time when the West celebrates any form of growth, no matter how miniscule. Fitch's credit downgrade of the US in August has added to concerns about the Western economy.

Gustavo Medeiros, Ashmore's head of research, believes that India is very much in vogue due to a combination of positive demographics, structural reforms and a favourable geopolitical position, which supports investment in the country. Added to that, India has an enviable scale. All of this amounts to it being one big engine of growth.

This is a point shared by Vivian Lin Thurston, partner and portfolio manager at William Blair. She says growth in India is being driven by a confluence of strong structural factors including, to some extent, a low base in terms of total GDP and per capita GDP, meaning "there is a lot of headroom for business for growth".

Land of plenty

This is backed up by the favourable demographics assessment, with a fast growing and young population and a vibrant private sector as well as an entrepreneurial and increasingly well-capitalised market economy. It also enjoys what appears to be a friendly and stable relationship with the US and the West.

"It is fair to say that the quality of India's GDP growth has been improving, with a higher share of investment going into manufacturing, which typically has a greater impact on the rest of the economy," Medeiros says.

The East is set to continue its economic rise, bringing with it an abundance of investment treasures, finds *Andrew Holt*.

James Donald, head of emerging markets at Lazard Asset Management, says India overtaking China to become the world's most populous country presents a compelling case for more investment opportunity over the next decade.

With its demographic dividend and nearly 80% of its population under the age of 50, India is projected to produce decades of growth until the 2060s.

India has all the positives going for it now, says Rob Brewis, manager of the Aubrey Global Emerging Markets strategy. These include positive government policies and accelerating urbanisation. "India has some decent, high return growth companies to invest in," he adds. Moreover, it will be the world's third largest economy in the next few years.

And for Alan Lander, investment manager at Walter Scott & Partners, which is part of BNY Mellon Investment Management, India's journey "has been one of the great economic tectonic shifts of recent decades". Yet, he says, "an air of 'promise unfulfilled' has often clung to the Indian economy".

Don't forget China

That perception, he notes, may well be about to change. "On track to surpass China later this year as the world's most populous nation, there is a growing sense that India stands on the cusp of an exciting new stage in its development," Lander says.

But one should not disregard China. It will still remain a big part in the story of the continuing rise of the East, despite not maintaining its pre-eminent position.

"China remains an important factor for future Asian growth, despite the expected decelerating of its headline GDP growth, with just 4% to 5% real growth expected in the next few years," Vivian Lin Thurston says.

In addition, she adds that China is also a major source of growth for some Asian countries within the wider rise of the East. This is especially true in the Association of Southeast Asian Nation countries, due primarily to high Chinese demand for commodities, the shift to relocate global supply chains and high levels of Chinese tourism.

Young blood

Also within the growth of the East is the shift in the measure of Asian GDP within global trade. The region claims around 60% of the world's population and around 45% of global GDP. The latter figure is expected to grow, with the prediction that this decade, and beyond, is likely to see a continued outperformance by Asia.

Medeiros has worked out the numbers to match these claims. He notes that the Indian economy was worth $3.2trn (£2.5trn) in 2021, which was only a fraction of the $17.7trn (£13.9trn) Chinese economy. If India's economy expands by 7% per year and China grows by 3.5% annually, India's GDP would stand at $6.3trn (£4.9trn) by 2031, compared with $24.9trn (£19.6trn) in China. In other words, in this scenario, India will add $3.1trn (£2.4trn) to global GDP by 2031 with China contributing $7.3trn (£5.7trn). Medeiros points to Indonesia, the Philippines and Vietnam among the countries that have the potential to add significant value here.

A point supported by Brewis, who says the most interesting countries of Southeast Asia are those with large and young populations. "Indonesia is perhaps the most interesting given the size of the population and the recent favourable direction of government policy," he says.

Tom Miedema, investment manager at Walter Scott & Partners, puts the case for another country that could help drive the region's GDP. "Taiwan is a small island with a small population and little in the way of natural resources," he says. "Yet it's a success story driven by the people and entrepreneurs that have led it forward over the last couple of decades."

There are, for Medeiros, several elements suggesting Asia will remain such a strong growth locomotive. These include a highly educated population, solid work ethics, a strong demographic profile – albeit there is a lot of divergence with China and Korea ageing while India and Indonesia keep expanding. Then there is a solid macro-economic framework – as inflation has been much less volatile across Asia – and structural reforms.

But for Lin Thurston, risks remain on the geopolitical front. If de-globalisation becomes more material and regional stability is challenged by tensions around Taiwan, then Asia's growth may be disrupted.

In addition, the macro, policy and political cycle domestically within these Asian countries "may also impact the trajectory of future growth, or, perhaps, that path is not going to be linear and straightforward as we have experienced in the past," she says. This presents a possible need for a cautious pause when looking the case of the East.

China remains an important factor for future Asian growth, despite the expected decelerating of its headline GDP growth.

Vivian Lin Thurston, William Blair

Political tensions

It is when framing the associated geopolitical risks that are perhaps the hardest to predict for the East. These are not, however, necessarily bad for the region. "We suspect that the willingness to reduce supply chain dependence on China will lead to more, not less, intra-Asian trade, as some companies relocate from but still have a significant share of the supply chain based in China," Medeiros says.

And where China is to face geopolitical tensions through negative outcomes, it is India that is expected to be a beneficiary, as US companies shift their supply chains from China. But the ongoing US-China tensions remain an overhang for Fabiana Fedeli, chief investment officer of equities in multi asset and sustainability at M&G Investments. This, she says, has manifested itself in a higher risk premium and lower valuations. "The tensions are unlikely to go away completely and their impact has to be considered when selecting stocks," she adds.

But there is an alternative scenario, one where the geopolitical situation can be cited in favour of the rise of the East. "We are at the beginning of an era of regional rather than global spheres of influence, which is proving beneficial for many smaller Asian nations, as well as larger ones such as India," says Will Scholes, fund manager at the Premier Miton Emerging Markets Sustainable strategy.

At the same time, and in another beneficial way for the East, Scholes observes that the increasing acceptance of the need for investors to support climate transition plans and broad-based electrification, which he sees in terms of the economic export 'pie' growing, is likely to be shared out more widely, with "exciting investment opportunities" in Indonesia, Vietnam and Thailand.

Even "China cannot be ruled out", with its dominance of many clean-tech industries. But still, it is India that looks best positioned with a 10-year investment horizon, Scholes says.

And for Paulo Salazar, head of emerging markets equities at Candriam, South Korea is poised to gain advantages from demand related to the US' Inflation Reduction Act, presenting yet another regional boost.

Electrifying growth

If this is the optimistic outlook, how should investors respond to this obvious opportunity?

Medeiros believes that Asia is the place to invest in structural growth stories. Here, he notes that other regions of the world may benefit from Asia's massive growth, as Asian countries are mostly net importers of resources. "When coupled with the energy transition, that will present good opportunities across the capital structure in different countries," he says.

Two large M&A transactions over the summer illustrate this well. Volkswagen purchasing 5% of China's XPeng and Saudi Arabia buying 10% of Vale's base metals business highlights that emerging markets hold the most assets and value in the electric vehicle (EV) supply chain, and trade at attractive valuations.

German companies have been rapidly losing market share to Chinese EV manufacturers and appear to be under pressure from their shareholders. "The transaction may be the first of many and highlights the challenges of reducing economic exposure away from China," Medeiros says.

Lin Thurston thinks that investors should continue focusing on a bottom-up approach in the region, to identify attractive investment opportunities with a "macro and policy consideration overlay".

On a more practical level, James Donald says investors should consider gaining exposure to the East, either through a regional Asian strategy, through a more diversified global emerging markets strategy, or a global equity fund.

Where's the gold?

So where are the specific institutional investment opportunities in the East?

In the equity space, India and Indonesia are great places to harvest growth, Medeiros says. He also cites Malaysia and Thailand as interesting due to their "idiosyncratic factors". He also lists Chinese stocks as a "value opportunity". Whereas Taiwan and South Korea will have a significant part of the artificial intelligence supply chain with a fraction of the levels of valuation from companies in the West.

Lin Thurston sees consumer and technology as the key sectors in Asia where potential long-term investment gains can be found.

Donald also points to Indonesia's growth prospects, which are also improving and "should not be overlooked" as it is climbing up the metals value chain, from mineral ores to processed metals to EV, as it is home to many of the key metals for such production, namely nickel, copper and bauxite.

He also breaks down the investor attractions by region and sector. In China: financials, consumer staples, healthcare and IT appeal. In Taiwan, it is IT, in South Korea: financials, consumer discretionary, communication services and consumer staples.

In India, he lists energy, materials and communication services. Within Indonesia, financials, communication services, industrials and energy standout, while energy and financials are appealing in Thailand.

Tech and growth

Tom Miedema puts the Taiwan tech industry as a hugely appealing investment. "TSMC is at the centre of that," he says. "being the global leader in semi-conductor technology."

Paulo Salazar says you cannot ignore China, with the current market scenario including new "secular growth themes" such as digital-cloud roll-out for Chinese enterprises, an advancement of high-end manufacturing and the integration of AI features by software and gaming leaders.

Here the rising demand for AI and ChatGPT-associated processing and memory semi-conductors is set to be a tailwind for selected companies in Taiwan and South Korea, Salazar adds.

And from a value chain perspective, he says multiple Asian companies are direct contributors to the AI theme's growth and are expected to be long-term beneficiaries of the transition.

For Fabiana Fedeli, there is also much for investors to look at within China. "Aside from all the macro-economic noise, we are encouraged by what is happening from a micro-economic or bottom-up perspective: a number of large Chinese companies are doing a good job in terms of margins and profits, despite softer-than-desired headline growth, and we are seeing many companies returning cash to shareholders in the form of buybacks," she says.

In its range and depth, the future of investment is clearly in the East.

We are at the beginning of an era of regional rather than global spheres of influence, which is proving beneficial for many smaller Asian nations, as well as larger ones such as India.

Will Scholes, Premier Miton

PRIVATE CREDIT: THE ZEITGEIST INVESTMENT

There is much to find appealing in private credit, says *Andrew Holt*.

Private credit is the subject of much discussion in the City and beyond. This comes within the backdrop of an evolution in the financial markets where alternative investments are becoming a significant focus. This has placed private credit centre stage. Indeed, it has emerged as a zeitgeist investment, amassing nearly $1.5trn (£1.16trn) in assets globally.

One of the key attractions for more long-term focused investors is that private credit looks set to be an area that may gain from the pressure on traditional banks and tighter credit conditions.

"Private market lenders have been taking market share from the banks over many years, but the pace of bank displacement has quickened since the Covid period," says Linda Desforges, private credit portfolio manager at Border to Coast.

Expanding on this point, she adds: "Private equity sponsors with companies that are focused on growth see the advantage of borrowing from private credit providers who can offer a tailored solution to the borrower, close transactions with speed and provide additional flexibility if required."

Much of this is connected to a new, more uncertain economic and political environment, where banks and regulators are more cautious. This can be seen by the tightening of standards in the US as highlighted in a first quarter survey of senior loan officers.

A narrowing market

Desforges places these developments in context. "The 2023 banking crisis, with the demise of SVB, Signature, Credit Suisse and First Republic Bank, added further pressures, at least on a temporary basis.

"This led to a narrower banking system, where banks prioritise healthy capitalisation ratios rather than creating new loans," she says, adding that tighter credit conditions are "supporting the attractive pricing environment currently available in private credit".

Stéphan Caron, head of EMEA private debt at Blackrock, broadly concurs with this picture. "Traditional banks will continue to play a vital role in the financing of economies, but private debt funds will continue to gain a higher share of the funding pie," he says.

This is all within the wider perspective of the private credit market being robust. A perspective highlighted by Lushan Sun, private credit research manager at LGIM Real Assets. "The private credit market has generally been resilient this year," she says. "The investment grade and crossover space has seen decent deal flow, pricing discipline, strong premium and, not forgetting, a higher yield environment."

Here, when discussing the banks, she says that it is important to "note that tighter credit conditions and bank retrenchment is likely to accelerate the shift towards private market financing".

Jo Waldron, head of client and solutions, private credit at M&G, reinforces the view that the banking situation will benefit the asset class. "Private credit looks set to benefit as banks continue to retrench from credit markets," she says.

"This continues the trend seen post the global financial crisis, with banks' willingness to lend being further curtailed by the macro-economic downturn and cautionary demise of Credit Suisse alongside a handful of smaller US banks."

For private credit this creates a wider opportunity set to step in with customised funding streams "for borrowers with lender interests at heart", she adds.

Different regions also offer different opportunity outlooks. In the US, there have been some interesting developments. Caron points to the widely anticipated contraction in bank lending, which could provide two tailwinds for private credit, especially direct lending.

"For one, an expansion of the addressable market of potential borrowers, including in the upper middle market. Then there is enhanced pricing power versus the public markets, reflective of the certainty of execution that private credit provides," he says.

In Europe, Caron continues to see wider adoption of private debt, in particular across Germany, the Benelux and the Nordics.

A step back in time

But there is another perspective. As private markets are complex, with some often having high levels of risk and volatility, they are therefore not suitable for all investors. Nevertheless, how should investors approach private credit given this aspect to it?

The answer for Caron is simple. "Investors have in recent years turned to asset classes such as private credit for income in a low-rate environment," he says.

And he shifts the risk debate to the appeal of the asset class. "Even as many central banks raise interest rates, the appeal of these assets persists," Caron says.

He expands on this point by adding: "While higher rates bode well for yields in public markets, they also portend even potentially more attractive returns for private debt holders across the spectrum of financing options, as many deals have floating-rate structures that lead to higher yields as rates rise."

One of the key drivers for the increased allocations to private credit is the low volatility versus public markets in addition to the attractive returns.

Caron believes that he may have seen something like this before. "The weak performance and market structure challenges in liquid fixed income with mark-to-mark dynamics is accelerating the barbelling approach toward passive and private assets – in the same way we saw in equities 10 years ago –

Traditional banks will continue to play a vital role in the financing of economies, but private debt funds will continue to gain a higher share of the funding pie.

Stéphan Caron, Blackrock

with a shift from active liquid allocations in favour of private equity allocations – whereas fixed income is still in the early stage of this evolution," he says.

A vast universe

For Desforges, it is pension pools like Border to Coast which have spurred on facets of private credit. The direct lending market: senior secured/uni-tranche debt, which is the most senior part of the capital structure with a relatively low level of risk and volatility and where the strategies are the least complex, is estimated to be worth $1trn (£780bn) and has been funded primarily by insurers, pension funds, endowments and sovereign wealth funds.

There are barriers to entry in terms of making a £500,000 minimum commitment and more sought after managers can be hard to access.

Waldron makes the point that at one end of the spectrum, private markets can be as complex as significant risk transfers, or fairly simple lending mechanisms such as leverage loans. "What they do consistently offer is an opacity and skill premium," she says.

Therefore, the benefits for including private capital in a portfolio are significant. "Given the breadth of the sub-asset classes within the universe, we believe private markets can offer investors unique diversification opportunities to help complement their existing portfolios," Waldron says.

Indeed, the range of options within the private credit universe is another part of its appeal, as it ranges from private corporate lending to consumer finance, real assets lending and structured credit – all of which have different underlying risks and performance drivers.

"Some are liquid, others are illiquid, some are investment grade, others high yielding, but most are cashflow generating propositions," Waldron says. "This provides opportunities for investors seeking a secure stable income stream returns at different stages of the cycle."

Waldron also highlights an important point that gaining entry to the private credit universe needn't be a challenge for investors. "As private markets continue to grow and develop, improved accessibility via a semi-liquid fund structure, and wrappers such as European long-term investment funds and long term asset funds are helping to redefine alternatives and opening the doors to unique opportunities across the private credit spectrum," she says.

In addition, it's important to note that there are two distinct markets within private credit – investment grade and high yield. "Investment-grade private credit has demonstrated its resilience over several economic cycles," Sun says. "High yield private credit – which includes direct lending – has a more limited track record as the asset class grew significantly in benign market conditions after the global financial crisis."

Sun, therefore, sees credit risk as becoming a more dominant driver in the coming months, as investors renew their focus on fundamentals, making asset selection critical. "Thorough due diligence, pricing discipline and stress testing in place are all essential to delivering strong long-term returns in private credit in our view," she says.

Re-pricing

The recent re-pricing in private credit serves as another opportunity for investors. "Yes, we believe private credit is attractive," says Desforges, reinforcing the re-pricing narrative. "For the lower risk direct lending strategy, the gross returns available have risen from around 8% in the first quarter of 2022 to around 11%, which has been driven by a move up in interest rates and a widening of credit spreads."

But there are issues. The net return, after fees and expenses, will be lower, while managers are factoring in higher than historical losses.

However, Desforges, says: "The net return will still likely be an attractive 8% to 9%, which compares well against the 6% net return that was anticipated for the strategy in early 2022, with a lower level of assumed losses."

For Caron, the re-pricing has created some complexity. "As we attempt to balance the narratives from multiple economic and market indicators, for allocators this creates a complex investing environment, which argues for focusing on quality companies with sustainable cashflows in defensive sectors," he says.

Long-term "mega-forces" still offer investment opportunities, he says. "Be that in healthcare, digitalisation or in the transition to a low-carbon economy.

"And we also continue to see attractive opportunities to finance, buy and build platforms in sectors ripe for consolidation, particularly in Europe," Caron says.

Moreover, yields are attractive relative to the historical average, thanks to rising base rates. But Sun says: "The macro uncertainty means that investors are increasingly cautious and selective, and rightly so in our view. For the time being we are maintaining our up-in-quality stance, favouring higher credit quality and defensive issuers."

Interestingly, the cherry picking by investors has led to growing divergence between defensive issuers and weaker, more cyclical issuers that need to offer better terms to attract interest. "This is somewhat different to the public bond market where spread dispersion across sectors is low within investment grade, with the exception of financials versus non-financials," Sun says.

Diversified and stable

Jo Waldron goes further, saying that with interest rate rises and ongoing volatility defining the new normal, private credit should be seen as an attractive source of diversified, stable income and uncorrelated returns.

"Recent dislocation and dispersion across credit markets provide an attractive entry point for investors, especially as lenders need flexibility and are willing to compensate lenders for this, leading to increased yields on offer for essentially the same credit risk," she says.

Furthermore, private credit's often floating rate nature embeds a level of inflation hedging in the return stream. "In the current environment it is able to offer real yield in comparison to traditional credit classes which struggle to generate real income returns above high single-digit inflation," Waldron adds.

The illiquidity premium available to investors from private credit makes the asset class compelling for pension funds.

Linda Desforges, Border to Coast

The attraction of private credit is therefore impressively wide ranging. "We now see a broader client base outside of purely institutional clients, such as wholesale and individual investors, looking to these more flexible structures to access assets which were historically only available through closed-ended funds, as they seek stable, long-term diversified portfolios," Waldron says.

How, therefore, should pension funds respond? "Bearing in mind that portfolio managers always tend to be biased towards their own asset classes, I would comment that pension funds should have a good level of exposure to private credit," Desforges says. "And any that are under-exposed should be looking to increase their allocation."

Defined contribution schemes could consider short-term alternative finance for its flexibility as part of a portfolio as members approach retirement, Sun says. "The short-term nature of the underlying loans you can target, coupled with maturity diversification, means that cash could be returned to the investor over a short period, with regular liquidity being generated," she adds.

Come on Rishi!

Going forward, the asset class is expected to deliver a good real return after inflation – assuming Rishi Sunak's ambition on inflation is successful – and here direct lending offers strong downside protection and low volatility. "The illiquidity premium available to investors from private credit makes the asset class compelling for pension funds," Desforges says.

Investor opportunities are, therefore, abound. "Riskier private credit strategies that offer credit solutions to companies that are facing distress are also offering good returns, but the lower risk part of the private credit spectrum perhaps offers the best risk-reward opportunity currently," she adds.

Not stopping there, Desforges also notes that asset-backed strategies are also attractive, albeit within commercial real estate debt their focus is on managers lending to the highest quality assets across the globe and have little exposure to office or retail. "Asset-backed strategies are also looking attractive, such as those focused on mortgage lending, SME lending, intellectual property, etc," she says.

Sun offers another insight given that interest rate rises have peaked. "As we approach the end of the hiking cycle, we believe duration looks more attractive and we will continue to seek opportunities to lock in long-term fixed-rate assets," she says. "The refinancing pressured faced by real estate debt borrowers may also present a window for investors to step in and provide financing on attractive terms, and we prefer resilient sectors such as residential and industrials."

This all adds up to private credit not just being talk, but an investment zeitgeist with substance.

pi ESG CLUB

What does institutional investors working to eliminate inequality in their portfolios mean for companies looking to attract and retain leadership talent? This month, the ESG Club looks at the difficult issue of executive pay.

Members

BlackRock

BNP PARIBAS
ASSET MANAGEMENT

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

INSTITUTIONAL INVESTORS CALL FOR HUMAN CAPITAL REPORTING TO BECOME A GLOBAL STANDARD

Human rights have become a key issue among investors, finds *Andrew Holt*.

An investor coalition that manages more than $1trn (£795bn) of assets is calling on the International Sustainability Standards Board (ISSB) to make human capital and human rights a priority for its next set of global reporting standards.

A letter, co-ordinated by responsible investment campaigner Share Action and signed by 21 investors across the globe, states that investor demand for a greater volume of better-quality workforce data "is at an all-time high" and urges the ISSB to "prioritise researching human capital and human rights disclosure standards in its upcoming two-year work plan".

The investors, which include a mix of asset managers and asset owners, say they have gone to the ISSB specifically in response to its Request for Information (RFI) – launched in May 2023 – seeking feedback on which area of sustainability to focus its next set of standards on.

James Coldwell, head of the Workforce Disclosure Initiative (WDI) at Share Action, said this is "an opportunity" for the ISSB to "set the global reporting baseline" needed for investors to be able to understand and take meaningful action on labour and human rights abuses.

Joined-up thinking

The letter also calls on the ISSB to consider "how to disclose human capital and human rights information together" by addressing the connections between the two topics.

It argues that in practice, neither companies nor investors treat the two topics as separate areas.

Human rights due diligence processes, for example, are used as key tools for identifying labour issues. Concepts such as unionisation and modern slavery belong to both categories, argues the letter.

"We know that workers around the world face exploitation by unscrupulous companies, harming the workers themselves and creating risks for investors," Coldwell said. "Tackling these issues can only be achieved when there is transparency around corporate practices – something the ISSB is perfectly positioned to deliver.

"This is why we're calling on them to prioritise research into human capital and human rights, to develop a globally accepted reporting framework," he added.

The letter follows a Share Action poll that gauged how British savers feel about where their money is invested. The results show the majority (74%) have a negative view of financial institutions that invest in companies which fail to meet human and labour rights standards.

Asset owner requests

It is an issue that has momentum. As it comes after the UN-backed Principles for Responsible Investment (PRI) also called on asset owners to include human rights in their request for proposals (RFPs).

To do this, the PRI has issued a guidaince for asset owners: *How to identify human rights risks: a practical guide to due diligence,* which highlights that "investors should, where necessary, prioritise companies with the most severe actual and potential adverse human rights outcomes".

The PRI said asset owners who outsource some, or all of their investment management, should set clear expectations to their asset managers in terms of how human rights risks are identified and prioritised, and ensure that they monitor risk exposure and actions to address issues via regular information from their fund managers.

The PRI suggested a prioritisation framework to identify and prioritise human rights risks: through sector, company and country assessments – which should be tailored to suit individual investment strategies.

The Council on Ethics of Sweden's AP Funds have also set up an initiative, backed by Railpen, to put tech giants on notice over human rights risks.

Financial materiality

The aim of the initiative is to make sure tech firms take solid measures to address human rights risks in connection to their products and business models, while encouraging greater transparency and reporting on the related impacts.

The group cited engagement with Alibaba, Alphabet, Amazon, Apple, Meta, Microsoft and Tencent during the next three years to assess progress.

Vincent Kaufmann, chief executive of signatory Ethos Foundation, a charity to promote well being in society, said Covid-19 – and the subsequent mass fluctuation it caused in the labour market – emphasised "how critical human beings are to the long-term success of any business".

And he added: "As the financial materiality of these issues becomes increasingly clear, it is crucial investors have access to comprehensive and comparable social data from businesses to help inform investment decisions. It is imperative the ISSB prioritises developing human capital and human rights standards as soon as possible to help deliver this."

The WDI has also announced that it is launching an investor working group focused on global social data reporting, which will be launched following the closure of the RFI in early September.

INTERVIEW – MAHESH ROY

"Big change, particularly at big organisations, takes time."

The head of the investor practices team at the Institutional Investors Group on Climate Change (IIGCC) talks to *Andrew Holt* about addressing the challenge of climate change, fixed income, framework fatigue, the rise of greenhushing and his concerns for the future.

How are you trying to make a difference in the fight against climate change?

IIGCC is one of the world's largest global investor bodies focused on climate change. It operates through three teams.

There is the policy team, which was formed 20 years ago to work with institutional investors on climate change. Then there is the corporate team, which has been helping investors engage with corporates since 2015, including via Climate Action 100+.

Finally, I lead the investor practices team to help institutional investors incorporate climate change into their investment strategies. This team was introduced in 2019 after what is now known as the Paris Aligned Asset Owners was formed. The initiative led to the development of the Net Zero Investment Framework, which marked a step change in how investors address net zero.

I started working in this space in 2020. During this period, we have seen rapid growth in companies and investors pledging their support to net zero as well as a greater scaling up on the issue.

The investors practice was only created in 2019. That seems a little late.

In terms of where investors were, it was the time when the [climate change] issue started to evolve. IIGCC had already been addressing it on a policy and engagement level for many years.

From the perspective of incorporating climate change into investment strategy at scale, it is relatively new. All the investor frameworks and alliances started around this time. The Net Zero Asset Owner Alliance, for example, was created in 2020 along with the Net Zero Asset Managers and Paris Aligned Asset Owners initiatives.

We can see, therefore, that a lot of progress has been made in three years. While some say we need to go further and harder, you have to remember the size of change we're talking about. In short: big change, particularly at big organisations, takes time.

What is the most challenging part of your role?

Prioritising what is important for our more than 400 members. They are mainly pension funds and asset managers spread across 27 countries, with around £56trn in assets under management.

We have so much to do and will focus on the work that will have the most impact. But it is a privilege to be entrusted to do this work.

How, in your view, are institutional investors approaching the climate change challenge? What are they good at and what needs work?

They approach the challenge, as you would expect investors to do, with rigorous analysis. They try to use the best available data.

Institutional investors have come a long way in a short period of time in net-zero investing. They most definitely take the challenge seriously.

On where there is more work needed: they haven't been so great at integrating physical climate risk into their investment decisions. But they understand there is work to do here and the need for marrying long and short-term risk.

Is there a difference in approach between how asset owners and asset managers are dealing with climate change?

Asset owners have a long-term view and have to make the necessary changes in

asset allocation while thinking more on a macro level.

For asset managers, they are for-profit businesses. They all have their specialities, and what they do is tied to the mandates awarded by their clients. There are boundaries to what they can do within those mandates.

What is important, and useful, is that the Net Zero Investment Framework is a common framework used by asset owners and asset managers on the issue.

Do asset owners or asset managers need to do more work on this issue?

There is evidence of lots of good work underway already. However, while asset owners may face challenges around resources, the larger asset managers arguably face the more complex challenges owing to the number and variety of mandates they have.

It's important to recognise that there are lots of different types of asset manager with different approaches, so it is hard to generalise.

However, what we can say is that any perceived slow progress in implementing net-zero plans is not for want of trying. We're seeing huge efforts here, including the building of entire teams.

Are the targets set by government and industry bodies stringent enough to address climate change?

At this stage, no. The Net Zero Investment Framework highlights the need for investors to be proactive in this space. But things have moved quickly and governments have generally been reluctant to regulate businesses because they don't want to curtail economic growth.

Some of the friction we are seeing is down to the fact that investors can only do so much on climate change. There is a need for certain bodies, including policymakers and regulators, to catch up to where investors are.

What needs to happen from a political and regulatory viewpoint?

Some things are happening. An example is President Biden's Inflation Reduction Act – which is designed to incentivise growth in the green parts of the economy. That helps to show where money should be going by sending the right price signals.

As far as regulation goes, first and foremost the net-zero initiatives and frameworks were always intended to be voluntary and be a guide for how investors could undertake things. They never have, and never will, aim to be quasi-regulatory. That is not their role, mandate or purpose.

One area where it would be helpful to have clearer guidance is on competition law and fiduciary duty. We've seen some positive and helpful signals in the UK and in Europe, which have made things easier.

There has been a spate of institutions withdrawing from climate change initiatives, such as the Net Zero Insurance Alliance. Why is this happening and does it worry you?

I can't speak for the insurers but there are reasons for joining different initiatives and there are different political risks in different geographies. It is worth noting though that a lot of those insurers with asset owner businesses are staying in those asset owner alliances.

This also highlights the different approach from insurers, who address risk, and investors who can see the investment opportunity presented by the transition to net zero.

The push back against climate change looks politically motivated, especially with an election coming up in the US. Is this worrying?

We are looking at changing some big engines of the global economy, so it is naïve to think that there would not be any resistance.

On a political level there are positive examples. If you look at the Australian case, it was shifted through an election by voters wanting to make a positive adjustment on climate change. In the UK and EU, if it is done in a fair and just way, there is support for the transition.

But there is friction in some areas. And there will always be that friction given how much we want to change. However, I am not worried that we are going down

the wrong track – overall, the momentum is clearly behind the transition.

The Church of England Pensions Board has left the Net-Zero Asset Owner Alliance. This was due to it also being part of the Paris Aligned Asset Owners initiative and it not being tangible to maintain two reporting frameworks. What lessons do you take from this?

The alliance and the framework are two separate entities focused on achieving the same end. Therefore, the Church of England Pensions Board decided to rationalise and go with only one of them. That makes sense from the administrative side.

In some parts of the wider press, it was presented as a bad thing and a worry, but that wasn't the case. In fact, it shows they are taking this seriously and working out the practical implementation of their plans.

Isn't the lesson though that investors could be getting bogged down by an excessive amount of net zero and climate change initiatives?

Ultimately, as long as there are the baseline standards, it does not matter what route to net zero investors choose, they are going to get there one way or another. Connected to this, we are looking at the best ways for investors to pledge their net-zero targets. As a lot of investor sustainable reports are patchy, we need to work towards more streamlined standards building on some of the good work to date, including the ISSB standards.

Do you support investors who wish to divest from companies which are failing on climate change, or prefer them to use their clout to drive change?

I wouldn't favour investors going one way or the other, without knowing their specific situation. But there are a few studies showing that mass divestment as a movement does not change the cost of capital for companies and that investment is still available even if others take a stand and divest.

Critically, we have seen that investor engagement works, as seen by the results achieved by Climate Action 100+. Ultimately, it can shift the way companies approach net zero and can move the dial over time.

In Australia, for example, we've seen the role institutional investors have played in getting Qantas to speed up their net-zero targets.

IIGCC created the Net Zero Standard for Oil and Gas companies. How will that help investors?

It offers a benchmark for investors engaging with oil and gas companies and the steps they need to take to align with net zero.

Setting out different aligning criteria and best practices, including transition plans, gives companies a benchmark. So when investors engage with oil and gas companies they know that they need to do x, y and z as there is a benchmark to refer to and measure them by.

IIGCC has issued net-zero guidance in an attempt to encourage bond engagement. What is the ultimate objective there?

A lot of the activity investors have had around climate change has been with equities. There is now a focus to put that on fixed income.

There are different levers and different ways of looking at fixed income, which is a large asset class. Ultimately, there is a question of how investors use their position as holders of equity and debt and the levers this gives them to support businesses make the transition to net zero.

How much of a problem is greenwashing?

The issues around greenwashing that emerged a few years ago have subsided to some extent. On a day-to-day basis, I do not come across it much, if at all. It is mostly used in advertising [of investments] to play up certain credentials, which are, in fact, not there.

There has been some good, clear guidance, particularly in the UK among regulators about what they will stand for and what they won't as far as climate claims go. Overall, we see little of it these days.

The term 'greenhushing' is more applicable. For instance, where [EU] Article 9 funds are moved to Article 8 because investors don't want to be seen pushing too hard on this. They want to be more understated than overstated.

What would you say IIGCC is good at and what needs improving?

We have been good at assisting and bringing asset owners and asset managers together to rapidly move towards net zero, as seen by the success of the net-zero initiatives. It has been more successful than we imagined two or three years ago and has been done in a partial policy and regulatory vacuum on how to address the goals of the Paris Agreement.

In terms of areas for development, we need to continue to make the case for net-zero commitments and to explain our role within this. For instance, we need to continue to explain that net-zero initiatives are there to provide a platform for ambition and disclosures, and to give an idea of what is possible into the future – not to act as a quasi-regulatory body or to police greenwashing. The aspirational narrative sometimes gets lost.

What are your hopes and fears in terms of institutional investors addressing climate change?

I hope investors continue at the pace and passion over the next decade that they have shown in addressing the issue in the last four years.

While the pace of change was always going to come up against some friction, including from organisational change management, we can't afford to see the pace slow too much during this difficult phase. Ultimately, I just hope organisations stay the course and keep up the good work as climate change is not going away.

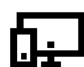
Manulife Investment Management

Opportunities for climate *impact*

Forests and farmland are increasingly recognised as economic and scalable natural climate solutions, and rapid increases in corporate and investor net zero commitments are leading to new opportunities to manage timberland and agriculture for carbon value.

As the world's largest natural capital investment manager,[1] we believe we're uniquely positioned to accelerate the use of nature-based solutions to help investors achieve their net zero commitments in the fight against climate change.

Discover how we help investors realise the possibilities.


manulifeim.com/institutional/climate-opportunities

1 IPE research as of 5/02/2023 based on total natural capital AUM (includes forestry/timberland and agriculture/farmland AUM). Firms provided AUM, where as of dates vary from 31/12/2021 to 31/12/2022.

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EXECUTIVE PAY: JUST REWARDS?

With concerns over social inequality growing, how much is too much when it comes to rewarding the people sitting in the boardroom? *Mark Dunne* reports.

Big is not necessarily beautiful. The rewards executives receive for leading a company are facing greater scrutiny as anger over inequality has led to strikes, protests and defunding campaigns. It's bad for business if directors receive six-figure salaries, bonuses, shares and pension contributions while the guys working on the shop floor are struggling on the minimum wage.

The chief executive of clothing and homewares retailer Next being handed a 50% pay rise at a time when families are struggling is the latest example that has put the issue under a microscope. Tesco and the Restaurant Group, which owns Wagamama, have also faced questions from shareholders concerning the rewards they have handed their leaders in difficult economic times.

Finding a balance between companies needing to attract and retain talent while avoiding accusations of being greedy is not easy. "Talent at the top can make a difference in terms of financial performance, but they need to balance having strong leaders with a prudent allocation of investor capital and robust, objective and transparent incentive metrics," says Peter Dervan, senior director of stewardship at Manulife Investment Management.

Karoline Herms, senior global ESG manager at Legal & General Investment Management (LGIM), has two decades of investment management experience, which has seen her work with companies on their remuneration proposals. "Remuneration has been a bit of a hobby-horse for me," she says. "It is a window into a company's governance structures, which, as an external investor, you don't often see.

"You get to see who is really wearing the trousers," she adds.

When is enough…enough?

Herms says that LGIM trusts boards to govern their company, which includes setting management remuneration. "Essentially, we trust them to do it right, but we take our responsibilities as an active shareholder seriously. We know our voting rights when looking at remuneration proposals and the accountability of directors," she adds.

The decision on what is appropriate to incentivise management lies with the remuneration committee. "If it is their belief that they must give a significant pay award, they can do so as long as it's structurally long-term aligned, reflects strong performance and is potentially measured against benchmarks," Herms says. "We want to see the management outperform the market.

"We also expect the committee to look at other issues. So, for example, the stakeholder experience, the size of

the company, market sentiment, and, especially if it is a large payout, potential reputational risks. These cannot be ignored.
"Ultimately, it is the committee's responsibility to persuade us that a pay award is justified," Herms says.
LGIM doesn't have a threshold for how much a company pays its senior leaders. A pay deal being linked to long-term sustainable performance is more important. "We look at the structure of pay and how it aligns with the experience of the workforce, of the shareholders and wider society," Herms says.
Although useful, the ratio of how much the chief executive is paid compared to that of an average employee can be confusing. "We accept that comparability is difficult across different companies and sectors. It is not a red flag for us," Herms says.
When assessing if an executive's pay is extravagant, comparing the pay structure to a reasonable peer group could help. "If a company pays its executives to a degree we deem excessive relative to their peers, we may have an issue with that," Dervan says.
"You need to incentivise executives to remain with the company, but success is defined potentially differently by different parties," Dervan says.

Cash or paper?

The structure of the pay package also needs to be considered. A large bonus may seem extravagant, but it could only be paid if the company hits certain targets. An executive receiving a $1m cash bonus, for example, is likely to be a different proposition from receiving the equivalent in shares. "We might have better tolerance for payments made in equity as opposed to cash if those equity awards are tied to strong operational hurdles. Achieving that equity payout could significantly enhance shareholder value," Dervan says.
It is not just a question of why an executive is being paid so much, but how, or when, it is paid. "Is it purely in their salary, where they just need to sit in their seat to earn pay, or tied to strong financial or operational metrics that could result in unlocking shareholder value?" Dervan says.
"We are long-term investors; therefore, we want pay packages weighted towards three-to-five-year periods," Dervan says.
"We want to incentivise outperformance against a peer group and we want to incentivise alignment with shareholders through equity ownership, so we want [pay packages] weighted more towards equity compensation than cash," Dervan says.
"We want robust challenging metrics over the longer term," Dervan says.

The right metrics

You want metrics that incentivise fundamental outperformance. Return on invested capital is such a measurement, which is weighted towards not just equity, but performance-related equity.

The wrong incentives can certainly threaten long-term value.

Peter Dervan, Manulife Investment Management

"You need to incentivise executives, but you need to do it in a responsible and reasonable way through a responsible and reasonable use of shareholder investor capital," Dervan says.
"The wrong incentives can certainly threaten long-term value," Dervan says. "That is why we work with companies to encourage the right metrics and the right incentives that seek to drive outperformance over the long term.
"You could have a good year of performance, but is that worth a significant increase in pay? We want to incentivise performance against the long term," Dervan says.
"It may not be enough just to look at stock performance. It is great if the stock price goes up, but we pick companies for a reason. We pick them because we expect them to outperform the market," Dervan says.
He doesn't want executives benefiting from just riding the market. "Some people could point to a share price going up over the last year, but if everybody's share price went up you have performed thanks to macro tailwinds. Nothing fundamentally has changed at the company," Dervan says.
"A revenue target could encourage executives to empire build, to just go after acquisition after acquisition without measuring the success of any post-merger synergies," Dervan says. "The right metrics, like return on invested capital, can help balance that."

Different strokes

It is difficult to compare the responsibilities of the directors to those of the wider workforce. "Directors are having to walk a bit of a tightrope here," Herms says. "Different risk and responsibility levels are rewarded differently.
"Executives are employees of a company and work on behalf of shareholders and other stakeholders, from the workforce to the supply chain," Herms says. "For that they are generally quite well paid. They get a salary, a bonus and participate in share incentives."

Clare Richards, director, social, in the responsible investment team at the Church of England Pensions Board, says that no one is saying everyone should be on exactly the same pay. "That's not the point," she adds. "It is about getting a more holistic sense of what rewards mean within a company, rather than just being fixated on one or two numbers."

Shareholders should not fall into the trap of high pay, means high reward. "Interestingly, we have not found clear evidence of a link between high pay and better performance, which is essentially what shareholders want," Herms says.

She points to research by not-for-profits and Morgan Stanley that shows high pay does not necessarily produce high profits. "In fact, over the years, their total shareholder return is less than that of other companies'," Herms says.

Under pressure

A wide pay gap between directors and the factory-floor employees could cause unrest leading to low productivity and strikes, which could ultimately impact profitability. "The biggest risk for a company is a disconnect between management and the workforce," Richards says, adding that it is all down to communication. Does the workforce understand that the executive team are driving the value creation needed to protect the jobs of the wider workforce?

There are other risks. "Consumer-facing companies could face a public backlash," Dervan says. "Consumers seeing such a wide pay gap between workers and senior management could become a brand reputation issue."

Manulife has enjoyed some success in ensuring that corporates are not being extravagant when paying their executives.

We have not found clear evidence of a link between high pay and better performance, which is essentially what shareholders want.

Karoline Herms, Legal & General Investment Management

This is the result of a mixture of policy and support for shareholder proposals to get boards to think about the ratio of CEO to median worker pay.

"We have seen more disclosure of that ratio," Dervan says. "We need maybe a little more of a history of data to see how it correlates to company performance and the workforce, but at least that data point is out there for boards and investors to consider."

Sustainable gains

Income inequality is not the only issue here. "This is another externality investment managers need to grapple with in sustainable investment, like climate change or water risk," Dervan says.

Herms says ESG issues can be financially material in the medium to long term, so this should be linked to executive remuneration but warns that when it comes to the metrics, there is no one-size-fits-all solution.

"Not all ESG metrics are made the same," she says. "It is going to be specific, based on the sector, and on where the company is in terms of disclosures."

Herms says that LGIM asks companies, especially those carrying higher ESG risk, to include relevant and measurable targets in their executive pay packages. "Our mantra is what gets measured gets done," she adds. "If the metrics have a direct impact on an executive's take home pay, the attention they give that will be manifold."

Including appropriate ESG metrics in executive pay is much more than just signaling. It should address financially material risks and opportunities. "We would expect companies that have a big influence on the climate to include climate transition targets in their pay."

Like emission reductions, and water conservation, these issues cannot be solved in a year. Dervan is seeing more companies including environmental and social factors in terms of their annual bonuses. "Right now, companies are comfortable in the one-year term, measuring these and incentivising them, but they are struggling with incentivising them over the long term."

Quantitative metrics investors can measure year on year include: how many tons of greenhouse gas emissions were reduced? How many gallons of water did you reduce? By how much did you reduce your exposure to deforestation in your supply chain?

Companies are integrating environmental and social factors into their executive compensation plans, but for Dervan, more work is needed in this area. His concern is these factors are not being included in longer-term pay packages.

Unless investors treat the topic of executive pay seriously, they could lose out while executives laugh all the way to the bank.

DISCUSSION: DC MULTI ASSET

For institutional investors, 2022 was an eventful year. There was volatility, inflation hit double figures and conventional investment theory was challenged.
But how has that changed the way diversified defined contribution (DC) portfolios are being constructed to mitigate longevity risk and further volatility? To find out, *portfolio institutional* sat down with a panel of those with influence on the defined contribution investment chain.

How do you see the new investment environment we are entering following last year's volatility?

Jos North: 2022 was the encapsulation of a new investment environment. When I say that, it often gets conflated to mean that what we experienced last year we are going to experience again and again and again. That's not necessarily the case.

However, some of the themes of last year, and in the wider post-pandemic era, are the big themes we need to think about as DC asset allocators.

For the 40 years to 2020, we had a period of declining interest rates. One of the reasons for that has been low and stable inflation. So we have had low real world volatility and low financial market volatility.

We are now in an era where, on average, we are going to have higher inflation. It probably will not be as high as it is today, but it is going to be higher than 2%.

There will be higher interest rates and higher volatility, so we need to think about the implications for investment strategies.

Natalie Winterfrost: Higher interest rates are an interesting challenge. People didn't want to take annuities because at the rates they were people couldn't afford to retire on an annuity. Hence, we saw the introduction of drawdown and investing through retirement.

We re-designed our default pots to target those. One challenge is: if annuities are priced on higher rates again, are we going to flip back to the idea that the security of an annuity is appealing if it is affordable? This could mean our defaults are targeting the wrong outcome.

More generally, because savings rates are too low, people need to invest in growth assets while they are saving. This can continue through retirement if they take the drawdown option. Hopefully, they are looking at real assets that will keep up with inflation, rather than fixed income markets.

We are also facing the levelling up agenda. The government wants DC money to support growth. Of course, they hoped the defined benefit money might do this but they have realised that it has a short life and so does not have the timescale to start allocating to infrastructure-like assets.

The question is: can that money come from DC? The early stage capital needed is probably a little too high octane for most DC members, but it is an area to consider.

The government wants your DC schemes to invest in infrastructure, Alan. Does that interest you?

Alan Pickering: Hands off! I have been

around long enough to have seen politicians at all points on the spectrum say that pension money is public money, therefore politicians should decide what to do with it.

It is the public's money and the public trust us to try and provide later life security. If one can do good with that money between now and when the member needs to depend on it, so be it. But we should not be the plaything of politicians. Government should stick to governing the country and let us govern pension schemes.

Lydia Fearn: The government are talking about DC schemes committing to a 5% investment in private equity. That will be interesting. The government clearly sees DC money as free wealth to them that will not just level up, but also boost the economy. That is something we are going to have to work with them on. It is not going away, even if we change government next year.

Jenni, you are a DC investment consultant. If one of your clients said the government wants them to fund new bridges and faster broadband, what would you advise?

Jenni Kirkwood: I would reflect on what my trustees have said to me, which is to approach with a healthy degree of scepticism.

First and foremost, they are making sure they deliver value for members. If what is put forward does that, then of course we are going to be interested. But we are not a nice little piggy bank which is effectively there to be raided to boost the latest political agenda.

There has been hilarity around the table when my trustees meet: "Here they go again." Trustees are savvy, they talk to each other, there are networks, so I get a feeling they will not be bullied into this.

Fearn: But it is being talked about more seriously than I have ever heard it before.

Kirkwood: It is definitely more serious this time. If it is well structured and could deliver then it might be a good opportunity.

Fearn: It is making sure that the people taking the decisions about potentially mandating assets understand the challenges we have been grappling with for years.

Callum Stewart: I picture various potential scenarios here. One is where the government mandates minimum allocations to the UK's levelling up agenda. That would create apathy around the overall view of a wider opportunity set, which could impact negatively on DC savers longer term in that it will constrain thinking around value. But it will be more to do with ticking boxes than thinking about what the member needs.

I would like to see a world where we are not constrained and UK projects could

Government should stick to governing the country and let us govern pension schemes.

Alan Pickering
President
Best Trustees

benefit from that, as part of globally diversified portfolios. But it will be a smaller piece of a bigger pie. The big pie being what is going to drive better outcomes for DC savers in terms of wider investment opportunity, not just illiquids.

Accessing the wider investment opportunity set might attract a higher cost point, but we should be less concerned about whether that is 20 basis points or 70 and be more concerned about whether a particular opportunity is going to improve outcomes longer term net of those costs.

We are not there yet. For me, the solution is to ensure we embed an unconstrained framework in the UK. There are different beliefs across our industry and there is little freedom to deploy them as cost continues to dominate focus. Providers are constrained because we know at the end of the story there is going to be pressure on cost.

Last year, we could have done better as an industry. The average return for an older saver was about -15% across master trusts, for example, reflecting an investment opportunity set constrained by cost. Some negative performance perhaps came from too much duration in bond portfolios, but shorter duration and global diversification would still have likely provided negative returns overall. We should be targeting much better outcomes, but it will require a higher cost point to get there.

Pickering: Where we can help governments is by being responsible investors. It is our role to make sure that whoever is investing and wherever they are investing, the money is appropriately deployed and well stewarded.

It is our job to make sure that what people save is put to good effect and they will get value for money. And in that way, hopefully, we will get growth and government will be able to get back to doing other things rather than trying to prescribe what we do.

Governments killed off defined benefit through over prescription. It would be sad if they were to kill off DC innovation by being similarly prescriptive here.

What lessons did you learn from the markets in 2022 that you will be putting into practice?

North: Diversification. There is a potentially beneficial outcome from the push into less conventional assets, whether it is government mandated or by design. That is, when thinking about the difference between the past 40 years and what we think of going forward, the trend for low interest rates has been a beneficial environment for all assets.

So just owning the market has been fantastic. Being equity heavy in the early phase of the lifecycle and then owning more fixed income later on has been a good solution.

We are probably now in a world where we might have a decade of not much in terms of market returns. In order to deliver the growth Alan was talking about, you will need to look for other assets.

On the growth side, you need other assets to get diversification and other forms of return. And that is addressing the savings rate point that was raised earlier. That is how you build up those savings.

But the real lesson from 2022, from our point of view, is that there is building up your savings and then there is maintaining what you have. When you start to think about retirement, starting to generate an income, starting to think about how big your pot needs to be to cover the rest of your life, suddenly holding on to what you have is important.

The way to do that has been a version of life-styling, so you become more fixed

income heavy as you get closer to the mythical endpoint of 65. But that does not work in a world of higher inflation.

Are frameworks helping here?

North: The frameworks with which we have looked at for asset allocation for 20, 30 years need to change.

It sounds like we will be still talking about the impact of 2022 in 15 years' time.

North: No, it could happen again in 2027 and we will be talking about that. Hopefully, our portfolios would have adapted by then so you would not get caught out.

Pickering: When you were describing 2022, you asked how we are going to cope in the new environment. There isn't anything new about 2022.

What goes around comes around. There will be another distortion or bout of volatility. The new environment is that members are now in the driving seat, whether they know it or not.

There is no longer an employer underpin and the new environment is the new working and saving environment. There is nothing magic about 65 anymore. We have to make sure that we have enough money to keep us going until 90 and we are going to have to flex the interaction between work and retirement, pay and pension. It needs to be a process rather than an event.

During the accumulation phase, we have to provide people with access to all of the asset classes DB has had but DC has been denied for all sorts of reasons.

We all want the same thing during the accumulation phase, we then have to bespoke it. In later life when people have to decide if they want to spend their money in Barbados when they are 70 or live in a nice nursing home when they are 85. They need to have an investment strategy that reflects their desired lifestyle.

The money has to keep growing. We can't stop it growing and just protect it at 65 when we have another 30 years ahead of us. That's the new environment, not 2022.

Fearn: We have been working on our soft default for retirement. This is thinking about pushing those growth assets much further out and looking at a potential moment, which is probably around 80ish, to annuitise. It might be some of the pot, it might be all of the pot; it will depend on the scheme.

The actual point of annuitisation is scheme dependent, and members can opt out. But it is this point of how to create a to-and-through investment strategy for members who after so many years suddenly have to make an active choice about their savings.

We are muddling our way through it at the moment because we don't have masses of DC generation yet. But when the DC generation comes through, we want to be prepared for that.

We want to help our members understand the beauty of saving, why it's right and why you need to invest over the longer term, but also how they then manage their assets until they can do whatever they want to do with it.

North: Do they start to take income but still with the aim of annuitising?

Fearn: It's called flex first, fix later. It is like drawdown. You don't have to think about 65, which is the moment schemes theoretically end. It is a long investment strategy that will be higher risk at that point, before moving seamlessly into a drawdown solution which kicks off income. At some point, members have to decide when to annuitise.

It is called a soft default, because at that moment you cannot just put members into a lifestyle default. They have to make a choice about what they want to do with their money.

North: Keep running your growth, start to introduce income but importantly you need to have some downside protection.

Fearn: Exactly. At the early stages, you can take a lot of risk. Later on, you can't.

Diversified growth funds are good for managing some of the risks, along with the other assets you are trying to protect. There is a question around cost and we would like a bit more complexity to manage that downside.

Kirkwood: It would be worth it at that point because it is keeping the money

If you start labelling some self-select options as green, some members are probably going to pick them because it fits with their own stance, rather than because it is an appropriate investment.

Natalie Winterfrost
Director
Law Debenture

safe, but to do that within the charge cap is challenging.

Stewart: We have made progress towards that. We have target-date fund approaches that expand to and beyond retirement. But for me, there are two bits needed to make that happen, which would make a huge difference in terms of value.

One is that most individuals who want to take an income in retirement end up in a situation where they move from an institutional world into a retail one. And there is an upfront advisory cost and ongoing costs of hundreds of basis points a year.

They are not in an institutional world, so maybe there is a debate around the level of governance rigour around the process and the quality of investments available. DC master trusts have the potential to do more for members and will have the benefit of scale going forward.

To me, an obvious value improvement we can make is to default at that point. If an individual does not make an active choice, they would remain invested and can draw on what they have built up.

To me, it does not make much sense to build up assets in one vehicle and then sell them to buy similar assets in another vehicle to then draw on and pay more for the privilege.

Fearn: Or to put it in cash.

Stewart: The other point is that annuitisation in later life, which is going to require an intervention from the individual, becomes tricky. Longer term, I can see a market for deferred annuities.

Fearn: That is what we are working towards, but it is not there yet.

Stewart: Agreed, we don't have the scale yet.

North: Callum, how are you thinking about DC portfolio construction?

Stewart: We need to strive for much better than we currently have. The impact of the environment we operate in today with an emphasis on cost is so constraining in terms of potential outcome.

Most trustees we speak to tend to support the idea that more freedom would be helpful to deploy different beliefs. If you look at the outcome differential we could have through a more unconstrained approach, within the master trust market the difference in retirement outcomes from worst to best is as wide as a 60% range for younger savers. That is within the cost constrained world. Price points sit within a range of 10 basis points difference from lowest to highest, so headline strategy still drives outcomes.

If we were to increase that by 10 basis points, we could improve retirement outcomes by well over 10% for younger individuals. If we could increase the price point by 20 basis points we could increase retirement outcomes by well over 20% for those individuals.

If we can introduce sophistication in the later stages, we could help avoid the issues we had last year where we are reliant on a constrained range of generally cheaper asset classes. We just can't rely on a constrained universe to provide the diversification we need.

So where should it go? I would have less reliance on traditional markets, specifically within bonds. Also, DC schemes generally under deploy to real assets such as infrastructure and real estate. There tend to be small and listed allocations to property and infrastructure rather than access to the physical underlying asset. We can do more there to diversify and offer long-term inflation protection.

But the crucial missing piece of the puzzle, given the completely different economic regime we are moving into – I say different because we don't know what it will look like in five years' time – is that we need to bring relevant expertise closer to the investment decisions. This means we need to carefully select fund managers

Providers are constrained because we know at the end of the story there is going to be pressure on cost.

Callum Stewart
Head of DC investment
Hymans Robertson

A bit more dynamism in investment strategies will be necessary if there is going to be more volatility.

Jos North
Investment director
Ruffer LLP

to help manage risk and deliver better outcomes.

That is important for older savers, where there are going to be some pretty turbulent markets to navigate. I don't think we can have faith that a low-cost world is going to provide adequate levels of protection. To me, paying a little bit more is protection, or insurance as we call it in day-to-day life. It feels right to consider paying a bit more if we can do better than -15% for older members.

Kirkwood: That is where we want to get to, but it needs to be in parallel with the development of investment platforms.

We need to avoid pricing errors. Every time we have a pricing error, it is bad news for our members. At the moment, a lot of platforms are going to struggle to do what you want.

Stewart: We need to put them under the lens and change them.

Kirkwood: There needs to be a seismic shift in the capabilities of a platform.

Fearn: What would drive that change? For master trusts it would be more business. But that is not going to work because if it costs more money, they are not going to win more business.

Stewart: This is where employee benefit consultants have a role to play. If we are evaluating the provider market, one of the aspects we should be evaluating is platform capability. If there is a capability that is inferior to the rest of the market, then that should be reflected in our view.

Fearn: We do that, but there are still employers who just go for the cheapest option. Even if you advise a client that this might be a bit more expensive but it will be worth it, you still get employers going for the cheapest.

There has to be a market shift. We have moved into a different investment environment, and with that comes cost.

If you are going to do ESG then you are going to need to think about more active investments, more active analysis. But it is difficult for a provider to breakaway and win business.

Kirkwood: This is not how it should be. It should be that you are the value player, you are good and everybody should flock to you. But you are just seen as expensive.

Stewart: The pace of change has been quite slow and painful in some areas. If we agree that change needs to happen then we need to drive it.

We need to empower policymakers with the information, knowledge and evidence that they need to change the regulations around this and have a freer framework to operate within.

North: The platform issue is important. If I can talk about it from a portfolio lens, a bit more dynamism in investment strategies will be necessary if there is going to be more volatility.

If you look back to last year, broadly over the whole year, you had a period of high inflation. But actually, in the first nine months, you had bond yields rising, bond prices falling and equities falling but then it switched in October and the dynamics changed.

We were having a conversation with a client yesterday who wanted to implement a new investment strategy and the pipeline was 18 months. We are talking about needing to change investment strategies quickly. You could do it within days by allocating to some active managers, but even at the strategy level, being able to move things around within a month is never going to happen within the existing infrastructure.

We don't know what is going to happen in the next 10 years. But I can say with a high degree of confidence that we are going to need to be much more flexible, much more dynamic in all investment strategies to move quickly once a decision has been made.

Pickering: I'm keen on broadening the asset classes that DC members are exposed to and I'm keen on finding roles for active managers, but I don't want to end up with churn.

Next year we will be investing in a lot of what we invested in this year, but it might need tweaking. We don't want to get so active that we almost become day traders. We are talking about a 50 to 60 year time horizon, so it is more tweaking, nuancing and reviewing. Then having reviewed, it is about implementing decisions quickly, rather than creating an atmosphere that encourages churn.

A lot of members these days want to use their money to make the world greener and fairer. There's a lot to consider when following such strategies, so how is that going?

Winterfrost: There two aspects to this. One, what do your members want to do that's based on their values and morals, but isn't a financial decision? And two, what do we think is the right thing to do as trustees for the bulk of our members?

It is generally accepted that if members have a good reason to invest in a certain way it will encourage them to save more, so offer the options they need. But it comes with a risk. If you start labelling some self-select options as green, some members are probably going to pick them because it fits with their own stance, rather than because it is an appropriate investment. Risk should come first.

There are dangers with fund labelling. But within the defaults, where we are making the decisions, it is about understanding the risks we are managing and what the opportunities are from incorporating ESG. It is widely accepted that there is an impetus behind transitioning to a lower carbon economy and, therefore, one can tilt the portfolio in that way and reasonably expect it to be a return enhancing or risk reducing measure.

Trying to address biodiversity is going to be more of a challenge, but the transition isn't going to be successful unless we deal with the biodiversity question. They are linked. But we are much further behind with biodiversity.

We have measures for carbon, which are universal, are global, whereas the biodiversity metrics being touted are local, making it hard to think of them in the context of a global portfolio.

If you do not appoint a manager that recognises and understands these issues and will engage with investee companies and then make decisions on your behalf, then you may end up invested in a company isn't managing these risks. That is a financial risk and it may become un-investable. As a trustee, we have to delegate quite a lot of this by picking the right partners.

Pickering: At the risk of sounding elitist, I am in the camp of engagement, rather than exclusion. The danger is that if members are in charge of their investment allocation they will go straight to exclusion. They will watch a TV programme tonight and tomorrow they will exclude any of their assets that were badly reflected in that programme.

With engagement you get two bites of the cherry. You might be able to make the world a better place and you might be able to improve outcomes.

Then we have to tell members what we are doing through our engagement strategy. If they want to drive their money to reflect their values, a self-select Isa is the right route rather than the pension scheme.

Pension schemes are capable of being well governed by the people around this table. Members should be told what is going on and that we are doing good stuff, but not have a plebiscite every day as to what should be excluded.

We are not a nice little piggy bank which is effectively there to be raided to boost the latest political agenda.

Jenni Kirkwood
Senior DC investment consultant
Mercer

We have moved into a different investment environment, and with that comes cost.

Lydia Fearn
Partner
Lane Clark & Peacock

Winterfrost: They will exclude all sorts without realising the consequences it will have on their portfolio. For many pension members, this might be their only savings pot and there is a danger that they will be allowed to take poor decisions on the portfolio they are reliant on.

Stewart: Engagement is definitely the preference. Where we start to lose faith is if the engagement is not successful, if there is no reciprocation to it.

There is evidence that engagement can drive change and improve the risk profile of an organisation that you may be investing in. You can add value for members longer term.

To Jos' point, we are moving into regimes where we have to change the way we think going forward. That applies to this piece as well. I struggle with the idea of just investing by taking a slice of the market as it looks today because most people agree that the world will look different in the decades to come.

So, should we be investing towards what we think the world will look like in the future? We can't predict that with certainty, but should we start to align that way at least? I feel that there is a stronger investment thesis behind that.

Expertise is then entrusted to manage that, but it requires a completely different mindset and more freedom in what we can do.

Jos, what is Ruffer's preferred retirement strategy? Could you give us an insight into what you guys are doing?

North: The role we are playing within our DC schemes is predominantly in pre-retirement, where essentially the diversification role that would ordinarily be provided by fixed income can no longer be provided in a world of higher inflation.

It does not matter whether it has a fixed end date, whether that be 65, or a deferred annuity or just needing to run growth, you need to have protection in the portfolio.

Whether it is building up the pot and protecting it for that endpoint, or to protect against sequencing risk, you are trying to make sure that your pot lasts longer than it might otherwise do. It is the ability to provide capital preservation and protection, which we did in 2000, 2008, 2020 and last year, which is pretty invaluable.

What is the investment strategy that you believe will appeal to DC schemes going forward?

North: Avoid static allocations to fixed income. Go from nominal conventional bonds or conventional duration-linked assets to having some real assets or inflation- linked duration. Be more dynamic. Think differently about protection.

Those would be the three main things.

What will be the biggest investment themes of the next 12 months?

Winterfrost: Illiquids, biodiversity and carbon.

Stewart: To add to that, the pre-retirement piece is the crunch point for members. We definitely need to be on that.

I'm supportive of illiquids generally, so I'm happy they are on the table. But we need to think about the crunch point for our members when they can have the opportunity to use their savings and protect them.

Pickering: I would rather think about what is going to happen in the next 10 or 20 years.

One thing I am going to be grappling with is what are the implications of more and more assets being within private markets rather than on public markets. And is that shift away from public to private going to have an impact? Or what will be the impact on our long-term strategy?

Indeed, will the pendulum swing back with public markets becoming popular again, or are we going to have to live long term with more assets being restricted to private markets rather than public ones?

THE *PORTFOLIO INSTITUTIONELL* AWARDS 2023

In the heart of Berlin, *portfolio institutional's* sister publication celebrated the great and the good of Germany's institutional investment industry in a glittering awards ceremony.
In 2024, we will be rewarding those who have shown leadership through best practice in the UK's institutional investment industry.
Could this be you next year?

GERMANY: ADAPTING TO A NEW WORLD

ESG, real estate and infrastructure dominated *portfolio institutionell's* conference examining where Germany's institutional investors are heading after a difficult 2022.

Last year everything changed. Conventional investment wisdom lost its certainty as bond and equity valuations simultaneously fell while consumer prices jumped. Indeed, they more than doubled to almost 8% in Germany, Europe's largest economy. It is difficult therefore to omit the country when assessing the global investment markets. For that reason, we asked our sister publication, *portfolio institutionell*, if we could attend their annual conference to discover what the issues are for Germany's institutional investors following such a tumultuous year.

The conference kicked off with Peter Bofinger, a professor of economics at the University of Würzburg, giving his view on whether the European Central Bank's monetary policy is too restrictive. He concluded that the decisions the bank makes are, at times, too dependent on data. So where does this leave ESG, given that asset owners complain about a lack of disclosure. Another issue is where should interest rates sit given the volatility witnessed in the bond and equity markets last year.

Rising interest rates could provide lenders with a buffer against future volatility. However, for Jim Caron, CIO for global balanced risk control at Morgan Stanley, there is no guarantee that the returns collected in the past few decades will be available in the years ahead. He expects higher correlations and that 2022 will not be an isolated case. "We had a big bond bull market for 40 years – that should be over now," he said. "Thus, in this new environment, there could be higher correlations over a three-year cycle and lower returns with volatility over five-to-10 years. "The 60:40 concept worked as long as bond yields fell," Caron said. "In the future, 60:40 will just be a number."

Dr Ulrich Kaffarnik, a director of fund manager DJE Kapital, agrees that return expectations should be scaled back. "But I don't share the view that the correlation between stocks and bonds will remain high going forward. That's why mixed portfolios like 60:40 will work well again in the future," he said.

Going green: challenging times

No matter how portfolios are structured in the coming years, ESG is likely to play a role. Yet investors face issues on conflicting goals, regulation and data. Asset owners are becoming so sophisticated in this area that some have created their own scoring system to assess a corporate's ESG profile.

These systems are not always positively viewed by asset managers, said René Hermanns, head of investment at the North Rhine Dental Association's pension scheme. "Different providers treat ESG reporting differently," Hermanns said, ranging from those who take ESG seriously to those who don't.

BVV Versicherungsverein des Bankgewerbes, the €33bn insurance association of the banking industry, has developed its own ESG reporting system. Head of risk, Christian Wolf, said: "We started implementing a questionnaire in 2018, which was sent to all external managers in the illiquid area," Wolf added. "Our questions were divided into policy, governance, ESG instruments and reporting."

BVV now sends its questionnaire to all asset managers and is part of its due diligence for new investments.

The North Rhine Dental Association's pension scheme, on the other hand, pursues a pragmatic and transparent approach. The scheme's asset managers are regularly asked how they classify the assets in their portfolios. "In numbers from one to 100, from one to five, or in school grades. That requires trust. If possible, the statement is confirmed by an auditor. That's what we're working towards," Hermanns said.

The scheme then converts this information into an in-house ESG score based on its own formula. However, this procedure must also allow for assets with a weak ESG score. "In addition to the current score, the trend in movement is particularly important. If the path is right, the score gets better from year to year," Hermanns said.

In sustainability, goals sometimes conflict, such as in real estate. Dr Jörg Mayer, head of finance at the Evangelical Lutheran Church in Braunschweig, found that in apartments and buildings rented by the church, there was a conflict of objectives between the social factor and earnings factor in renting below market value and meeting the parish's financial obligations. This shows why it is important for investors to clearly communicate their goals: is the focus on the social component or on income?

On the subject of sustainability in real estate, Philipp Lehner, senior vice president and managing director at Alliance Bernstein, admitted that "the industry is struggling here". Real estate per se is an "ESG offender" due to CO^2-intensive materials such as concrete and steel. But energy efficiency is an area where the asset class is creating sustainability.

Safe as houses?

Property is a big topic among pension schemes and insurers, so it was not surprising that as a theme it continued throughout the conference. Rising interest rates, higher construction costs and shrinking values mean trouble for real estate in Germany. Indeed, real estate and infrastructure have been sought-after asset classes, but interest rate rises have made traditional interest-bearing securities more attractive again.

Yet infrastructure credit offers a good risk/return profile, and there are arguments for equity investments. "As an infrastructure equity investor, you have an upside," said Charlotte Daelemans, senior real assets specialist at Nuveen.

Sebastian Dooley, senior fund manager at Principal Real Estate, touched on digitalisation. But data centres need for energy is immense. The industry is working to make their systems more climate friendly by signing power purchase agreements with wind farms or hydroelectric power plants. This turns conventional data centres into "green data centres", he said.

From an ecological point of view, however, there is another problem: the sharp rise in energy prices, so data centres must continue to make their systems more efficient.

Dooley added that this is important because without ongoing digitalisation there will not be a green future. "I advise institutional investors to work with operators and investment managers to promote efficient data centre expansion, especially in mechanical and plant engineering."

So data centres might be greener than you expect, but motorways are difficult to associate with the adjective "green".

Manuel Cary, founding partner and CEO of transport infrastructure investment manager TIIC, admitted that roads have a negative impact on the environment as green areas have to give way for the construction of the asphalt strips.

But work is being undertaken to minimise the damage to the environment through building automated toll roads where drivers save fuel by not having to stop to pay the toll.

Inflation protection was also on the agenda with Cary saying: "I've supported the theory that infrastructure serves as a hedge against inflation. But for a long time I didn't have the opportunity to prove that. Now asset valuations have benefited from the rise in inflation."

When asked what "the next big thing in infrastructure will be" aside from decarbonisation and electrification, Cary outlined two short-term trends in Europe. One is the increasing use of the railways for freight as trucks are inefficient.

Second, he sees a trend in the intersection of climate change, infrastructure and water management. "It's not just about using less water in agriculture. It's about how you deal with the fact that it will rain heavily in a short time as a result of climate change and you have to catch the water somehow?"

For Cary, solving this will require enormous investment. "That's going to be a big revolution in infrastructure," he said.

In view of rising interest rates, falling valuations in some real estate segments, there is great uncertainty among investors where fair value is concerned. This is reflected in the lack of transactions with buyers and sellers rarely coming to an agreement currently, in favour of a wait and see approach.

Concrete gold

Is "concrete gold" now losing its lustre after some residential and commercial properties as well as riskier developments changed hands at dizzying prices but are now threated by valuation corrections.

When asked whether real estate would become a "problem child" in the future, the participants, including Thomas Gut, head of real estate at Hamburg Pensionsverwaltung, unanimously opted for "concrete gold".

While Gut sees opportunities for diversification "in the current situation of re-pricing", Dr Miriam Esders, a sustainability specialist at project developer Freo, stated that real estate could become a problem child thanks to poor ESG quality. "But if you do it right, we have a chance at concrete gold. We are of the opinion that sustainable development and investment does not have to mean less return," Esders said.

These can both be achieved through carrying out the energy renovation by using technology to lower costs. "There are some challenges that we can only successfully meet by thinking outside the box," she said, referring to climate change.

Following a difficult time last year, and with questions about how return can be earned, it is now business as usual for Germany's institutional investors in making assets greener and driving digitialisation in Europe's largest economy.

INFRASTRUCTURE: BUILT TO LAST?

Infrastructure could be a stable investment in uncertain times, but where is the opportunity and are investors ready to grasp it? *Fiona Nicolson* reports.

Just as the Covid-19 crisis started to fade, more trouble appeared on the horizon to dominate the economic environment. At one end of the scale, the eruption of the war in Ukraine and at the other, rocketing inflation and interest rates.

Some asset classes have struggled amid the storms of the 2020s. But, according to Preqin's 2023 global report on infrastructure, investors "flocked" to unlisted infrastructure in 2022 "amid rising inflation, a global energy crisis and intensifying pressure to accelerate the energy transition".

The data provider also forecast that it would be the second-fastest growing private asset class on the basis of asset under management. Its end of year report anticipated a 13.3% compound annual growth rate (CAGR) up to 2027, behind venture capital at 19.1% CAGR over the same period.

Infrastructure, which emerged as an asset class more than a decade ago, has evolved in that time. Described by McKinsey as "traditionally staid and stable," the consultancy says it has been shaken up "by revolutions in energy, mobility and digitisation", with next-generation assets emerging, such as battery storage, smart motorways and data centres.

Standing strong

There have been some bumps in the road, though. Preqin's Q1 2023 infrastructure report acknowledged a "difficult start to 2023" due to a slower pace than anticipated with $3.1bn (£2.4bn) raised by 11 funds. This is only 9% of the quarterly average of the past five years. But the report also said that "the asset class is on the right trajectory, longer term".

Survey results, published in July, by real-asset investment manager Patrizia have affirmed the enduring attraction of infrastructure. The firm's third annual survey of its international institutional client base found that more than half (60%) of the 122 respondents are planning to expand their allocation to such assets during the next five years. It also showed that 11% of these investors are planning to do so by more than 10% – a drop from last year's 20%, which Patrizia attributes to "the more tentative outlook on the current market environment".

Commenting on the infrastructure trends revealed in the survey, Graham Matthews, the firm's chief executive of infrastructure, said: "Investors understand that the global megatrends of decarbonisation, digitalisation, urbanisation and demographic change make the long-term picture for infrastructure highly attractive."

Its reputation for stability is another reason why investors expect to increase their allocations, as Darryl Murphy, Aviva Investors' managing director of infrastructure, says: "Investors recognise that infrastructure provides long-term, stable cashflows with good linkage to inflation.

"It has proved itself resilient to economic downturns, as witnessed during Covid and through other recent macro-economic challenges," he adds. "It also exhibits strong ESG characteristics, which an increasing number of institutional investors want to see reflected in their exposure to the sector."

Marija Simpraga, infrastructure strategist at Legal & General Investment Management Real Assets (LGIM), also points to the attractions of resilience and stability. "As infrastructure has emerged as an investible asset class over the last 10 to 15 years, a big part of the story has been about access to stable and robust income."

She also highlights how institutional investors are increasingly aware of the opportunity in infrastructure – in debt and equity.

"To gain exposure to resilient cashflows underpinned by robust fundamentals and strong ESG credentials," Simpraga says.
And Jerome Neyroud, head of infrastructure debt at Schroders, anticipates that infrastructure will stay steady. "In our view, valuations are likely to go down in private equity. But we expect real estate and infrastructure to remain more stable and hence we will see a flight to quality from investors."

Strong and stable

As well as revealing plans to increase allocations, Patrizia's survey discovered that almost half of investors expect a pickup in infrastructure transactions and opportunities during the next 12 months. Also, around a third of investors expect recurring income to improve this year, and more than half (55%) anticipate recurring income from infrastructure to be stable.
Tom Maher, Patrizia's managing director of infrastructure, said: "Despite the economic uncertainty, the essential nature of infrastructure, combined with the tailwinds provided by the global megatrends, continue to drive demand and revenue for infrastructure."
Looking at listed infrastructure, as well as at infrastructure generally, Nick Langley, a portfolio manager at Clearbridge Investments, points to the themes and trends that could produce an ongoing source of income and capital growth.
"Given the multi-decade themes of decarbonisation, greener transport and 5G rollout, more infrastructure assets will be created in the coming years, which will generate greater cashflows and support attractive investor returns, including income and capital growth."
Daniel McCormack, head of research at Macquarie Asset Management, believes that the drivers of income growth will vary this year.
"For some assets, the link between inflation and cashflows will drive income," he adds. "For others, it is the exposure to structural demand trends of digitalisation, energy transition and demographics. While for some, company-specific business plans are driving the expansion in income."

Themes, trends and opportunities

Reflecting on areas of infrastructure that investors are considering, other than traditional assets such as roads, bridges and airports, Murphy says: "The energy transition requires significant investment over the next few decades and that will continue to provide the principal opportunity for infrastructure investors."
It is not the only growth theme in the sector. "Over the past few years, the other major growth sector has been digital infrastructure, namely towers, fibre and data centres," Murphy says. "This sector will continue to grow globally, although investors are increasingly cautious around the issues of scale and competition in local markets."

Themes and trends we're looking to avoid would be so-called 'next generation' infrastructure assets.

Dan Ryan, Fidelity International

McCormack takes a similar view. "Demand for greater data connectivity has been growing rapidly, subsequently driving a demand for the infrastructure to facilitate that growth – such as data centres and fibre networks. We expect this to continue to grow rapidly in the future, particularly given the number of data-intensive technologies emerging, including driverless cars, the Internet of Things and AI, among others."
But there is still room for the traditional, core infrastructure assets, along with the more contemporary ones. "Traditional assets such as electricity and gas distribution networks remain a key part of any infrastructure portfolio. And as our energy system changes and evolves there may be an increased need for both of these types of assets," McCormack adds.
Patrizia's survey results echoes the focus on these trends, finding that institutional investors are largely focused on decarbonisation during the next five years and that more than a third (35%) plan to increase their exposure to telecommunication infrastructure and fibre.
As with all investments, there are risks, and in infrastructure there are themes and trends to be bypassed, says Dan Ryan, a portfolio manager at Fidelity International. "Themes and trends we're looking to avoid would be so-called 'next generation' infrastructure assets that appear to be stable, secure and anti-inflationary, like traditional infrastructure assets, but actually hide secret correlations to commodities, economic growth or evolving regulation and technology risk. Some areas of energy transition, transport and digital infrastructure can show this trend."

Why so low?

Research published in June by capital advisory firm Hodes Weill and Cornell University's Program in Infrastructure Policy, also concluded that institutions are "poised to continue allocating a significant amount of capital to new infrastructure investments".

The survey, which sought the views of 63 institutional investors across 16 countries, revealed that 60% of respondents are under allocated to infrastructure.
The report said that sentiment towards private infrastructure remains relatively strong, but on average, global institutions are under-allocated to the asset class by 98 basis points relative to their targets, supporting expectations of increased capital flows into the sector.
Mark Rudovic, principal and head of real assets at Hodes Weill, said: "Despite systematic risk in the form of the denominator effect plaguing private market allocations during the last 12 months or so, sentiment towards infrastructure amongst allocators remains positive given the resiliency of performance through a rising interest-rate environment, heightened geopolitical tensions, high inflation and global supply-chain challenges impacting all verticals of infrastructure."
Inflation will, inevitably, be a big factor. "Infrastructure remains a particularly favoured asset class for institutional investors, and the inflationary risks affecting other asset classes will drive capital to infrastructure as a safe haven, as asset owners are often able to pass through rising costs, demonstrating resilience in the face of a slowing economy," Rudovic says.
Commenting on why there is a lack of exposure to the asset class, Andrew Cox, co-head of infrastructure at Allianz Capital Partners, said: "The reasons will vary between investors. However, infrastructure is a relatively low-return asset class, historically seen as secondary to private equity, which has higher but more volatile returns, but has also benefited significantly from the lower interest-rate environment since the global financial crisis."
Cox does expect this under-allocation to rebalance somewhat in the current geopolitical and macro environment, as "investors look for more stable and predictable returns".

[Infrastructure] has proved itself resilient to economic downturns, as witnessed during Covid and through other recent macro-economic challenges.

Darryl Murphy, Aviva Investors

Headwinds

Assessing how investors are navigating geopolitical and macro-economic headwinds for the asset class, Simpraga says: "When it comes to investors committing new capital to the sector, while a lot of macro-economic uncertainty persists, institutional investors are focusing more and more on the 'super core' assets which benefit from traditional infrastructure core qualities, such as high barriers to entry, quality and cashflows visible for the long term. These types of assets will tend to have more inflation protection built into the revenues, while their valuations may be less affected as more investors seek out quality assets.
"This trade-off between cashflows and valuation is something investors will need to continue to work through until the uncertainty in the macro-economic environment clears," Simpraga adds.
There are other challenges and risks afoot, despite an upbeat outlook for infrastructure, McCormack says. "Given its defensive nature, healthy yield and inflation hedge characteristics, we believe infrastructure is well placed to deliver relatively good returns in the current environment."
That said, McCormack sees the outlook for GDP growth as concerning, which could be challenging for some infrastructure assets at the higher end of the risk spectrum. "Interest rates have also risen sharply over the last two years and the full impact of that may be yet to fully play out, although this has implications for all asset classes," he adds.
And investors will need to remain alert, to make the most of the opportunities, Murphy says. "The ability to parse longer-term thematic trends will be increasingly important, to capture outperformance. Infrastructure investors will need to be able to identify key economic, political and technological developments in order to identify the right assets. The risk profile of different types of infrastructure is likely to change as these trends play out, necessitating continual reassessment to keep portfolios future proofed."
Murphy also observes how rising rates, technological innovation and climate change will mean the next 20 years of infrastructure investment will look very different from the last 20. "But one thing is certain: investors will have to leave their comfort zones if they are to grasp the risks and seize the opportunities," he says.
Will investors embrace these opportunities to build infrastructure into their portfolios?

THE FINAL COUNTDOWN

1.7%

The expected decline in headline UK dividends during 2023 to £92.3bn, a £1bn improvement on previous projections thanks to higher cash returns by banks in the second quarter.

Source: Computershare

2050

Only around 60% of companies are on track to achieve their net-zero target by 2050.

Source: Fidelity International

62%

The level of British pension funds which have not invested in natural capital despite being aware of biodiversity risks.

Source: Pensions for Purpose

81%

The level of professional investors who believe that global macro-economics are an important factor in portfolio construction.

Source: Fulcrum Asset Management

59%

...of institutional investors intend to increase their illiquid investments, while 26% plan to "dramatically" increase their exposure to such assets.

Source: Aeon Investments

53%

...of DC schemes have, or are considering, altering their investment strategy in response to current economic challenges.

Source: Aon

60%

The level of local government pension funds and DC schemes who favour private equity as the vehicle to make an impact with their capital.

Source: Pensions for Purpose

€13.8bn

The net outflows from Europe-domiciled long-term funds in June ending two months of positive flows. Economic uncertainty has been blamed.

Source: Morningstar

€1trn

The record assets under management held by European equity ETFs in June.

Source: LSEG Lipper

Quote of the Month

"There is stuff you worry about, stuff you don't worry about and stuff you pay someone else to worry about."

Andrew Harrison, LawDeb Pension Trustees

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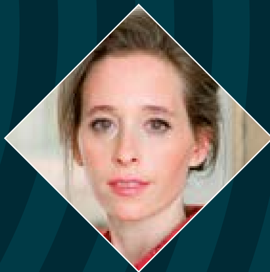

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