PORTFOLIO INSTITUTIONAL OCTOBER 2023

pi

HEDGE FUNDS:
TO THE RESCUE

THE US
End of an era?

SUSTAINABLE DEBT
Clean money

BERKSHIRE PENSION FUND
Beating benchmarks

Issue No. 127 | www.portfolio-institutional.co.uk | Independent analysis for institutional investors

Pensions
Management
Institute

TRUSTEE WORKBENCH

2 November 2023 | 08:30 - 18:00

For more information,
visit our webpage:
pensions-pmi.org.uk/events

10+ speakers

Venue:
Allen & Overy LLP,
One Bishops Square,
London E1 6AD

Pensions
Management
Institute
Events

HEDGE FUNDS: TO THE RESCUE

The time has come. The moment that justifies the decision to diversify institutional portfolios has arrived.

With markets and the macro picture so unpredictable, the only issue that appears certain is that there will be volatility. And such conditions have boosted the attractiveness of hedge funds as a driver of alpha.

Historically, the asset class has delivered in such times. The question we ask in this month's cover story is: can they deliver again? Find out from page 16.

Also in need of a saviour is the US. With the country experiencing economic and political turmoil, some are questioning if it's losing what made it exceptional during the 20th century.

With another divisive election looming on the horizon potentially causing further uncertainty, which US sectors could benefit long-term investors and which should they avoid? We take a look from page 20.

Meanwhile, closer to home, British pension schemes have fallen out of love with domestic equities. Research shows that such ownership has collapsed to less than 2% as schemes look globally for their risk assets. The lack of sexy tech stocks has also been blamed.

Yet some believe the returns from holding the right shares could be attractive and that valuations are improving, so should pension schemes be more optimistic? Find out from page 38.

Most British pension schemes are, however, focused on making a positive impact on the environment and creating a more equal society. Their fixed income portfolios are a big part of this strategy, so we look at how they are lending sustainably from page 32.

We also speak to Damien Pantling, head of the Royal County of Berkshire Pension Fund, about investing in infrastructure on their own terms, the three elements of his investment philosophy, preparing for cashflow negativity and embracing pooling. The interview starts on page 12.

Finally, we look at how a change of strategy at the Church of England has seen Dan Neale take the reins on social issues. Read how he is shaping such investments and how the church is tackling climate change and nature-related risks from page 28.

We hope you enjoy the issue.

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

IN THIS ISSUE

INFLATION: A STICKY PROBLEM

Inflation is on the decline, but the risk it poses is not, says *Andrew Holt*.

I feel like Morrissey from The Smiths singing, *Stop me if you have heard this one before*, but: inflation is still a problem.

I can cite as my star witness none other than US Federal Reserve chair Jay Powell. "It remains too high," he confessed of inflation at the Fed's annual symposium at Jackson Hole in August. And when Powell speaks in such terms, it indicates something serious is happening.

This is despite US inflation standing at 3.2% in August. Then there was, of course, the unexpected fall in UK headline Consumer Prices Index (CPI) inflation. It slipped from 6.8% to 6.7% during August, versus the Bank of England's consensus of 7.1%.

More importantly though is core CPI inflation, which recorded a sharper fall. It slid from 6.9% to 6.2%, despite the 6.8% consensus, while services inflation declined from 7.4% to 6.8%, smashing the Bank's 7.2% expectation. The latter is key when the Bank judges the persistence of domestic price pressures.

It led to the Bank ending a run of 14 straight interest rate hikes in September. With the narrative being that inflation is stabilising.

As part of this narrative, the Bank said it expects inflation to fall to around 5% by the end of this year. It then expects the cost of goods and services to keep falling in 2024 before reaching the Bank's 2% target in the first half of 2025.

Longer-term problems

But Richard Tomlinson, chief investment officer at Local Pensions Partnership Investments, says this is unlikely to play out over the longer term. "In the short-term, inflation is coming down.

"It is coming under control, with rate hikes doing their job. But it will be harder to get long-term inflation back to what we were used to, say at 2%.

"Long-term inflation will be higher due to geopolitics, supply chains, demographics – all those things – structural factors," he added.

A point shared by Richard Bullock, Newton Investment Management's senior research analyst in global macro-geopolitics. "It's too early for many Western countries to declare victory over inflation," he said. "The challenge is not so much in headline inflation, which will come down with food and energy base effects, but in core inflation, in which costs of labour and services remain elevated."

There is within this something of a new reality, added Bullock. One that "in labour markets is a function of demographics – retiring baby boomers – and geopolitics: more protectionism and lower labour mobility. Geopolitics and de-globalisation also mean that inflation is likely to remain sticky and higher".

Taming inflation

Shweta Singh, chief economist at Cardano, the investment group behind Now Pensions, is also full of warnings about the inflationary threat.

"Even if inflation is now tamed for this cycle – we don't think that it is – wages continue to grow at a brisk rate and well above the level consistent with the Bank of England's 2% inflation target," he said. "Underlying inflation pressures remain sticky and are likely to stay elevated over the next 12 months," he added.

Sebastian Vismara, an economist at BNY Mellon Investment Management, is also concerned about the sticky nature of inflation. "UK wage growth data keeps surprising to the upside relative than the Bank's forecasts, and core inflation remains high and has been sticky, at least until recently. Energy prices have surged in the past few months and could increase further."

Vismara makes the valid point that the global economy has been weakening since the last quarter, but not by enough to create much slack.

"In other words, there remains the risk that this easing in core inflation proves to be another false dawn, and that the fall stalls or even reverses in the coming months."

And he added: "The Bank is likely to want to see broader disinflation trends in play before ending its hiking cycle."

The Paris-based Organisation for Economic Co-operation and Development (OECD) has also lined up to give something of a warning shot across the Bank's forecasts.

The OECD said in its interim economic outlook published in September that it expected UK inflation to average 7.2% during 2023 – significantly higher than the Bank's expectations. This is also a rise on the OECD's 6.9% forecast in June, which suggests that things are not under control in the way the Bank has indicated when it comes to inflation.

Collateral damage

And Blackrock has given an even starker warning. It noted in one of its outlooks that bringing inflation down to the Bank's target entails crushing demand to meet constrained supply, meaning significant economic damage – a potential more worrying outlook than the spectre of inflation itself.

Given the situation, it is not surprising that 70% of pension funds manage their assets to an inflation-plus benchmark, according to investment boutique Alphareal.

It all adds up to a bleaker inflationary picture than is being presented. Investors need to therefore proceed with caution.

WELCOME TO THE NEW WORLD OF DEFINED BENEFIT PENSIONS

A Society of Pension Professionals' report gives a comprehensive insight into the challenges final salary schemes could face.

The Society of Pension Professionals' (SPP) Vision 2030 report for defined benefit (DB) pension schemes gives a detailed account of the dynamics that have shaped, and will continue to shape, the challenges such schemes face.

The report comes when many DB schemes are on track to achieve their endgame objective of self-sufficiency or an insurance buyout within 10 years.

Pension schemes have become the focus of intense scrutiny during the past 18 months, in the wake of the gilt market volatility of late 2022 and the Mansion House Reforms announced by Chancellor Jeremy Hunt in July.

A call for evidence from the government on options for DB schemes has sharpened the focus on their future further. Indeed, it is against this backdrop that trustees face big questions about their investment strategy and how to achieve the best outcome for their members.

The report reveals that schemes are in much stronger funding positions and invested in lower-risk portfolios than they were 10 years ago. Unsurprisingly, schemes hold much larger collateral buffers following the gilt liquidity crisis. There is now a greater focus on building investment resilience, including avoiding being a forced seller of assets.

There is an emphasis on physical investment in gilts, and assets which offer contractual cashflows and a return over gilts, such as high-grade corporate debt, are likely to form the core of most schemes' investment strategies going forward.

The resilience question

As a result of the crisis, many schemes have found themselves with a higher exposure to illiquid assets than they would normally have. Here the report asserts that resilience is not purely a question of asset allocation, and significant challenges remain that trustees need to consider.

The report also highlights the systemic risks associated with inflation hedging. "The inflation hedge of a scheme is imperfect because an RPI asset is used to hedge an inflation-linked liability, where the inflation linkage of the latter is limited by caps and floors," says the report.

It also highlights how legislative, regulatory and tax framework adjustments following the Department for Work and Pensions' (DWP) call for evidence, could impact how trustees view options before them – that is for schemes' long-term investment strategies and endgame options.

In addition, the report gives a thumbs up and a nod to The Pension Regulator's (TPR) subsequent guidance on the issue, which outlined what trustees should consider regarding liability-driven investment (LDI), which included the need for resilience testing, effective governance and resilience standards.

It noted, however, that since the revised code of practice on compliance with DWP's draft regulations on DB scheme funding was first touted, changes in scheme circumstances have raised questions as to its applicability and relevance.

Here the Work and Pensions Select Committee has already asked TPR to postpone the launch of the code before the next general election – raising doubts about when, or if, it will be implemented in its current form.

Key changes

The report also identifies five key developments experienced by British final salary schemes.

One, most schemes (51%) were closed to new accrual in 2022, compared to 26% in 2012. Two, most are paying out more than they receive as they are no longer accumulating assets.

Three, the majority of pension scheme allocations are in bonds, not equities. DB schemes' allocations to equities have almost halved from 53% in 2006 to 27% last year. At the same time, the allocation to bonds has more than doubled to 59% from 23%.

Four, liability hedge ratios have doubled. Data, including industry surveys, suggest the average liability hedge ratio for UK DB schemes has risen to more than 80% from 40%.

Five, funding ratios have improved substantially. Gilt yields fell between 2012 and 2022, but they have risen strongly since the beginning of last year. With the average scheme not fully hedged, this has improved many pension schemes' funding levels.

This is clearly illustrated in the funding ratio of schemes eligible for the Pension Protection Fund soaring to more than 140%.

Funding levels

Against the backdrop of funding levels hitting their highest this century, and most pension funds closed to new members and largely closed to accrual, trustees are reconsidering their endgame targets, the report concludes.

As a result, a record-breaking amount of pension capital is expected to transfer to insurers over the next few years. But the report warned of "the systemic risks to which insurers are exposed," which, has also been highlighted by regulators.

Commenting on the findings, SPP president Steve Hitchiner said: "The lifecycle of DB pension schemes has reached a critical tipping point. Schemes are, in general, continuing to mature and, following a decades-long battle against deficits, funding levels have improved with many schemes now finding themselves in surplus on a low-risk basis."

For more on this paper, turn to page 10.

PEOPLE MOVES

Scotland's second largest local government pension scheme has welcomed a new head of investment.

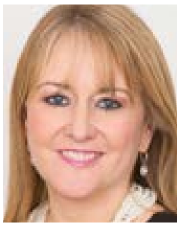
Emmanuel Bocquet (*pictured*) becomes **Lothian Pension Fund**'s chief investment officer from November.

He replaces Bruce Miller at the £9.6bn scheme, who is retiring but will remain at the scheme until January to ensure a smooth transition.

Bocquet will join from pension fund consolidator TPT Retirement Solutions, where he has spent the past seven years building and managing portfolios for multiple schemes.

Prior to TPT, he spent more than 10 years at the investment management arm of National Grid's UK pension scheme.

Helen McEwan has become a trustee of the **Legal & General Mastertrust**.

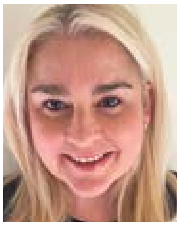


She joined from USS, where she was chief pensions officer, and replaces Moira Beckwith, who stood down after six years on the board.

McEwan (*pictured*) is also the senior independent director and investment committee chair at Exeter, which provides income protection, medical and life insurance products.

Professional trustee provider **Independent Governance Group** has continued to strengthen its team through the appointment of three new members.

Nicole Mullock and **Jo Holden** join as trustee directors while **Aziz Jalil** becomes associate director.



Mullock has a 20-year track record of working with trustees and large corporates having held positions at GSK, Waters Corp and Buck.

She has worked on buy-ins as well as led pension scheme governance teams.

Holden (*pictured*) spent four years as a non-executive trustee director of Charterhouse Pensions. Before that, she was head of governance at the HSBC DC Master Trust. Holden will focus on governance and risk management.

Investment management and asset liability management specialist Jalil has held leadership positions at Credit Suisse, Mercer, Russell, KPMG, Aviva and Athora.

CALENDAR

Themes for upcoming *portfolio institutional* events:

October
– Fixed income roundtable

November
– DC investing roundtable

November
– Sustainable strategies roundtable

December
– Real assets roundtable

25 April 2024
– Private markets conference

Finally, **LawDeb** has strengthened its offering by naming **Scott Pinder** as its new head of corporate sole trustee.

Pinder joined the trustee specialist last year following a 15-year stint at Willis Towers Watson, where he was a director.

The appointment comes at a time when more and more schemes are appointing a corporate sole trustee to oversee their governance in the face of growing regulatory demands.LawDeb acts in this capacity for around 60 schemes.

NOTICEBOARD

BAE Systems' defined benefit pension schemes have completed Britain's largest outsourced chief investment officer (OCIO) agreement. The trustees have handed the management of their £23bn of assets to Goldman Sachs.

The in-house investment teams of the **BAE Systems Pension Scheme** and **BAE Systems Executive Pension Scheme** will join Goldman Sachs by the end of the year.

Meanwhile, the trustees behind five pension schemes sponsored by property and construction group **Keir** have appointed Schroders as its OCIO to manage their combined £1.2bn of assets.

Also outsourcing its CIO function is the **Northumbrian Water Pension Scheme**. It has selected **Cardano** to govern the scheme's £830m worth of asset allocations.

This will include reducing sustainability risk across its debt and equity holdings and managing the scheme's liability hedging portfolio, which will be managed by Cardano in-house on a segregated basis.

Pension Insurance Corporation (PIC) has invested an undisclosed sum in a plot of land where it will build a 147-home retirement community.

The project in Brent Cross, London, will be built under the Mayfield Village brand and is part of a wider project that could add 7,000 homes to the housing stock in the area.

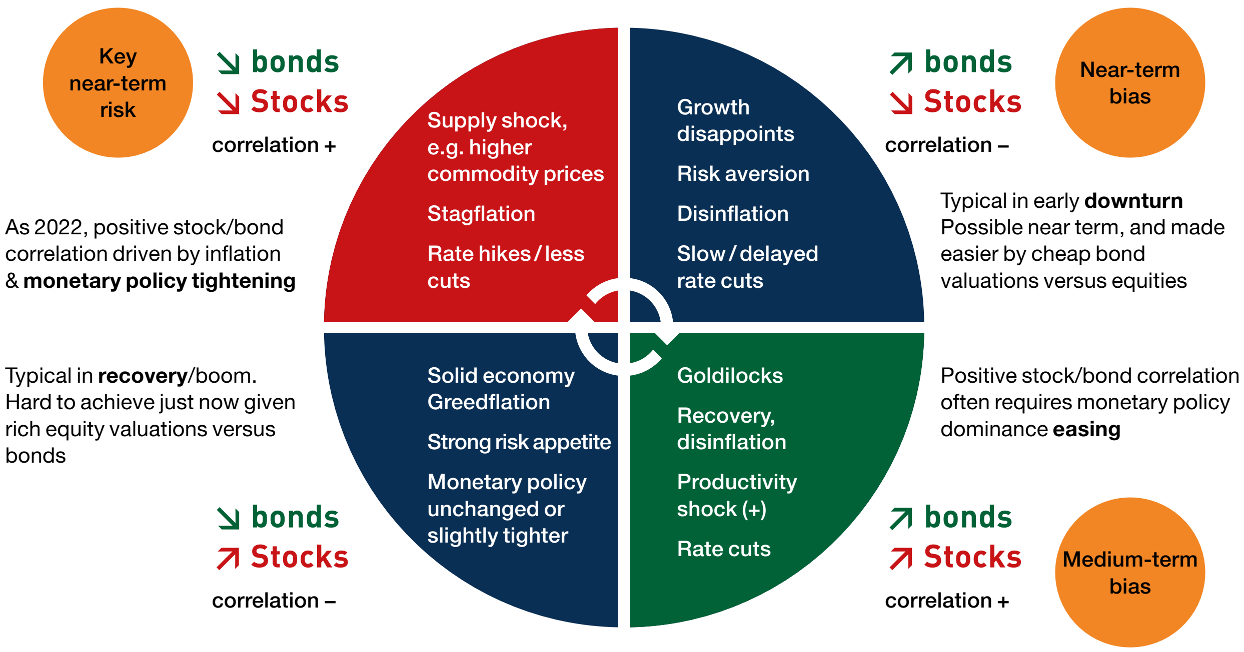
The deal was completed through a partnership between Senior Living Investment Partners, of which the defined benefit scheme risk insurer is a member, and retirement property investor Audley.

This is the second such deal funded by the two following the acquisition of Headley Court, Surrey, in July.

Finally, **the Association of British Insurers' Pension and Assurance Scheme** has de-risked all its longevity liabilities following an £18.4m deal.

The buyout, which was backed by **Just**, secures the benefits of all the scheme's remaining 16 pensioners and 118 deferred members.

THE BIG PICTURE: INVESTORS FACE RISKS ON MANY FRONTS



The short-term picture is full of risks, finds *Andrew Holt*, which can mean opportunities and challenges for investors.

Looking to the end of 2023 and into 2024, many risks exist which are likely to have ramifications for investors.

For example, the surge in oil prices adds new stagflation risks. Brent prices have climbed to around 25$/bbl in the three months to late September – just 3$ below the 100$ mark.

This is most unwelcome for investors, as this will keep headline inflation higher in the final quarter of this year and hurt growth.

The price pressure reflects a shortage of supply, after OPEC+ cut production targets, under the leadership of Saudi Arabia and Russia. Although, this must be seen in the context of a moving geopolitical environment, with Saudi Arabia joining the BRICS group.

On the political front, 2024 will see EU and US elections where inflation and immigration are major concerns for the incumbents.

Joe Biden and Ursula von der Leyen have run highly active energy transition policies, and it is not in the interest of the fossil energy industry to support their campaigns. Investors may thus face the risk of higher energy prices for longer into those crucial elections.

Using an interesting investment clock device (*pictured*) to assess the outlook, Generali Insurance Asset Management looks at stock and bond performance from the correlation angle.

Correlation is positive in the top left – bottom right diagonal, and negative in the other.

Generali's view is that markets will turn the year in the top-right corner, with the global slowdown capping bond yields and hurting a generous earnings consensus and equity valuations.

Consensus has US corporate earnings up 12% for 2024 and 2025, and up 7% for Europe. This looks optimistic and subject to downward revisions, Generali said.

The key risk is that global markets turn the year in the top-left corner, as rising energy prices, and possibly food prices, as El Nino disrupts the agricultural complex, keeping inflation high and central banks hawkish.

Longer term, Generali expects a transition to the bottom right corner – more bullish within six to 12 months, as the Fed starts to consider rate cuts by mid-2024. Sustained commodity price inflation may well delay that transition.

A near-term defensive bias also lies in the valuation gap between 'risk-free' bonds and equities. Furthermore, rate volatility has been high relative to equity credit and FX volumes, and this has played against bonds.

Equity markets delivered solid year-to-date gains into the early summer in the context of a continued central bank quantitative tightening. But with the latter comes the risk of some payback to a quantitative easing-furled risk rally.

Therefore, it is safe to say, the future is full of risk for investors, which, if navigated well, can offer opportunities as well as challenges.

Simon Daniel is deputy chair of the Society of Pension Professionals' investment committee.

A DIFFERENT LANDSCAPE FOR UK DB SCHEMES

It has been 11 years since SPP published its *Vision 2020* paper and, while it's impossible to predict the future, the 2012 edition turned out to be quite prescient – at least in one respect. That concerned the observation that UK defined benefit (DB) schemes' collective demand for index-linked gilts substantially outstripped the available domestic supply. This demand-supply imbalance led SPP to expect sustained upward pressure on index-linked gilt values, and corresponding downward pressure on yields, over the decade ahead (which proved right).

Vision 2030 has been published at a rather different time for financial markets and UK DB schemes. With yields higher, many schemes' funding positions have surged from deficit to surplus. Even on the most prudent bases, and trustees and corporate sponsors have been accelerated along their journey plans, finding themselves ready to consider securing their scheme's liabilities with an insurer.

And so, as we look ahead to the next decade for these schemes, and the challenges to navigate investing their £1trn+ of assets, the importance of running a resilient portfolio which is able to withstand market dislocation has gained prominence. Accordingly, a key theme of the 2020 paper is also a key theme of the 2030 vintage – whether the way in which schemes manage their inflation exposure (through recalibrating their conventional and index-linked gilt holdings) is potentially susceptible to inflation expectations moving in the opposite direction from their upward trajectory of the past 12 months.

The explanation for the concern the paper identifies in relation to inflation is technical, but boils down to the fact that, because schemes' inflation-linked liabilities typically carry a floor of zero, trustees will not want to be holding index-linked gilts at a time when markets are expecting a period of deflation and, if schemes are seeking to offload their unwanted linkers into a thin market with weak sentiment at around the same time, the hallmarks for systemic risk would seem to be present.

Managing illiquid asset allocations is the second key challenge that our *Vision 2030* paper identifies for DB schemes, particularly where their endgame is full buyout with an insurer. While schemes, insurers and their advisers are actively innovating to find solutions to the problems (for premium payment) posed by outsized illiquid allocations, an inopportune illiquid allocation can, at best, complicate a transaction and, at worst, hold a scheme back from achieving its objectives.

No commentary on the years ahead for UK DB schemes could ignore the ineluctable – and sharply accelerating – growth of the buyout market, so our paper considers the differences in regulation and investment approach for insurance companies compared with DB pension scheme trustees when it comes to decisions around investing assets held to back liabilities and maintaining appropriate capital buffers against downside risk.

But there are warning signals too, with Andrew Bailey, governor of the Bank of England, noting that the buyout boom could expose the insurance sector to "larger and more concentrated exposures to similar types of risks" which could potentially impact the capacity of surviving insurers to take on the back-book of a failed insurer. It is for a similar reason that Charlotte Gerken, the PRA's director for insurance supervision, has called for "moderation" amongst bulk annuity insurers, saying they should balance short-term incentives with the need for "long-term and enduring financial strength".

In that context, the paper considers the availability of the Financial Services Compensation Scheme (FSCS) and identifies its potential vulnerability to a change in the PRA rulebook and its status as an unfunded lifeboat with recourse only to levies on the insurance industry, both of which mean that, in a crisis scenario, the full availability of FSCS support could be dependent on political sentiment.

Stepping back, *Vision 2030* surveys a different landscape than in 2012, with schemes generally in much stronger funding positions and running lower risk portfolios. This has brought the endgame within reach for many over the next decade but, with that, comes a different set of challenges to manage and some important strategic questions to answer around the merits of buyout versus run-on.

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

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

Deputy editor
Andrew Holt
a.holt@portfolio-institutional.co.uk

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

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

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

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

Daniel Loughney is a fixed income portfolio manager at Border to Coast

FIXED INCOME BACK IN FASHION A YEAR ON FROM CRISIS

A year on from the mini-Budget that triggered the gilts and liability driven-investment crisis, Daniel Loughney discusses the resurgence of the asset class.

Fixed income is back in fashion, competing as an alternative investment to traditionally higher yielding riskier assets from a return perspective, as opposed to just portfolio diversification. It's had a rocky journey to this point, of course.

After more than a decade of low yields for income investments, global bond yields began to reverse course in 2021 as the market anticipated higher inflation in response to the huge monetary stimulus during the pandemic. This trend accelerated with the Ukraine conflict as commodity prices spiked and supply chains became constrained.

And when the Kwarteng/Truss mini-Budget of autumn 2022 brought about a UK government fiscal credibility crisis, domestic gilt yields positively surged. They have remained elevated, with gilt yields now at levels last seen in the 1990s/early 2000s, as inflation fears proved correct and expansionary fiscal policy led to a significant increase in bond issuance.

Now the interest rate landscape is far more attractive for those looking for a return from bonds. Government bonds and high-quality credit will be a natural beneficiary when we experience bouts of volatility as economic growth slows.

Medium-dated gilts now yield 4.5%. With inflation metrics slowing and bond volatility falling, gilts are appealing, with index-linked bonds – where price and coupons are linked to inflation – look compelling with a real yield above 1%. Credit spreads over government bonds have widened as yields have increased, leading other fixed income sectors to offer attractive valuations for their risk profile.

We are cautiously optimistic on investment grade debt. The rise in absolute yield levels provides an income buffer though not total protection against a sell-off in an economic slowdown. Weaker growth is likely to weigh on corporate profit margins and cashflows but yields of around 6% on sterling investment grade credit provide a healthy cushion to any further spread widening.

Emerging market sovereign debt looks interesting at current spreads of more than 4% to US treasuries as the average subsequent 12 month return when spreads get to this level is more than 10% for hard currency bonds. The market does face the headwinds of slowing developed market growth and weakness in China, but the US dollar will likely stabilise as Fed Funds are close to their peak, while inflation is declining quicker than in developed markets.

Higher yields provide less comfort on high-yield debt, however. Such companies tend to have greater leverage, lack pricing power, run on thinner margins and cash buffers, and face a higher wall of maturities. This could prove problematic over the near term.

Though the profile of fixed income appeals to long-term investors, LGPS funds have historically held modest allocations due to a lack of liability driven reasons for doing so. Without an attractive return profile versus other asset classes, there was little appetite for fixed income.

With the improved funding level of, and greater need for cashflow in, the LGPS there is scope to increase holdings at higher rates and higher funding levels.

Economic sentiment is weakening and forward-looking measures of activity, such as money supply, are falling, while inflation has pulled back from its high and is expected to gravitate back to 2% over the medium term.

The major central banks are communicating that official interest rates are at or near the peak and financial markets are pricing in rate cuts next year. Though yields are likely to remain elevated for a while, and bouts of volatility expected – perhaps in response to geopolitics – we believe the market has priced in sufficient risk premia and yields will move off their highs in the not-too-distant future.

While the economic landscape is subject to change, as a long-term investor, we believe bonds, including those that are inflation linked, currently provide 'a two birds with one stone' opportunity; generating attractive income and also helping to match a portion of liabilities.

Design and production
portfolio Verlag

Printed in the UK by
Stephens & George

FSC www.fsc.org MIX Paper from responsible sources FSC® C013417

Subscription rates
UK £300 (9 issues),
Single issue price: £35
Overseas €350 (9 issues),
Single issue price: €40

Subscriptions
Claudia Ajagbe
c.ajagbe@portfolio-verlag.com

© Copyright portfolio Verlagsgesellschaft mbH. All rights reserved. No part of this publication may be reproduced in any form without the prior permission of the publisher. Although the publishers have made every effort to ensure the accuracy of the information contained in this publication, neither portfolio Verlagsgesellschaft mbH or any contributing author can accept any legal responsibility whatsoever for any consequences that may arise from errors or omissions contained in the publication ISSN: 2045-3833

INTERVIEW – DAMIEN PANTLING

"I don't think anybody has been able to keep up with inflation and liability growth over the past three years."

The head of the Royal County of Berkshire Pension Fund talks to *Andrew Holt* about infrastructure, future proofing, maverick managers, a pensions skills shortage and funding.

What's in your portfolio?

We have about £3bn in assets, but more than £3.6bn of liabilities. Right now, we have three broad asset classes: equity, debt and real assets.

We have the highest combined exposure of public and private equities than any local government pension fund.

On the debt side, we invest in private credit, multi-asset credit, investment grade and government lending.

In real assets, we invest in real estate and infrastructure equity.

It's probably worth noting that the bulk of our real asset exposure comes from infrastructure equity. We don't invest in hedge funds or other low beta diversifying strategies. That's perhaps something to look at in the future.

You mentioned infrastructure equity, which is on the government's agenda. Is that commitment a result of this, or is it something you have always been keen to embrace?

We are not driven by the government's agenda at all. Infrastructure has been part of our strategy since 2016. It's largely the other characteristics infrastructure brings, such as index-linked cashflows, and a stable source of income which works with our long-term investment approach.

What is the philosophy that underpins your investment approach?

We have several objectives in our investment strategy statement, and a lot of them work in tandem with each other. But our philosophy can generally be categorized into three distinct areas.

The first is diversification. That comes from asset classes, styles, strategies and geographies.

Second is a long-term approach or long-term focus. The opportunities that come with that are mainly in the liquidity premium.

Third, it comes from good governance and an ESG focus, which speaks for itself. But, in essence, good companies will create and hold value over the longer term.

You have consistently matched the actuarial annualised benchmark of 6.5%: what do you attribute that to?

We set that 6.5% benchmark in March 2019. Annualised performance from then until July 2023 has been just over 7.5%, on a money-weighted basis.

The best performing asset classes during this period have been private equity and infrastructure. Since we set that benchmark, we've been able to achieve [the benchmark] largely by maintaining our focus on growth assets and liquid alternatives.

Generally, our performance has been held back by our exposure to real estate. We realigned our portfolio in March this year, not just for that basis, but that was one of the considerations.

In your investment statement you state the pension fund will progressively evolve to being cashflow negative. What is the rational here?

In simple terms, this is to do with the evolution of the membership and the

membership profile of the fund. It applies to virtually all defined benefit schemes.
With the passage of time, we see the proportion of retired members compared to our active and deferred members increasing. With that, we have more money being paid out in retirement benefits compared to what we have coming in from member and employer contributions.

It is often said that this puts the fund in a risky position. Do you identify with that, or do you look at it another way?
It's a great question. But I look at it in a slightly different way. When we discuss cashflow negativity, we are referring to our dealings with our members rather than our investment activities. So in our investment strategy, there is plenty of harvestable income: we simply reinvest to compound that up.
If we suddenly went cashflow negative tomorrow, we will be able to meet those demands without selling anything.
In essence, we can always start to harvest the income rather than reinvesting it, then over the long term we have the scope to amend and shift our investment strategy, should we need more assets with a higher income yield in the portfolio.
I don't think our glidepath to cashflow negativity puts us under any undue risk as an important part of this journey is closely monitoring the cashflow profile as our cashflow position progresses.

You mentioned your change in portfolio earlier in the year. How has the inflationary environment impacted your investments?
It is a highly relevant and topical issue. To answer it we need to think about when the high inflationary environment really began, and how the portfolio has performed since August 2020.
Over that three-year period, the consumer price index has inflated average consumer prices by just under 20%. But our fund has returned just over 24% in that same period.
Looking at that alone, one could say we've

> **"In essence, good companies will create and hold value over the longer term.**

been highly resilient in a high inflationary environment. But being resilient to inflation alone is not enough as DB schemes in general need to outperform inflation by about 2.5% on an annualised basis to keep up with the pace of accumulation in their liabilities. But Berkshire needs to outperform by a further 1% to counter the historic under-funding position.
It's probably worth noting that at Berkshire we have ranked in the top three funds for performance in the whole of the local government pension scheme universe [PIRC data set] during that period.
If we were not in such a strange and uncertain macro environment, I'm sure you would agree that 24% asset growth over three years would have been considered excellent.
But like any institutional investor, I don't think anybody has been able to keep up with inflation and liability growth over the past three years.

You must still be pleased with that type of performance.
We are, but as a DB fund, we don't just look at our assets. We look at our funding ratio assets versus liabilities.
So liabilities are growing at more than 5% each year – even more when inflation is high – and our job is to match, or beat that, otherwise our funding level deteriorates. I guess that's the real difference between DB and defined contribution schemes, where DC managers only look at one side of the funding equation.

So you've not had to respond too much in terms of adjusting your investments?
It's an interesting point to consider. The investment community is aware of the two lagging asset classes over the past three years: debt/credit and real estate. Debt comes as no surprise, but we generally keep that in our portfolio as a diversifier rather than a growth asset.
What's really been a surprise to us is real estate. This asset class has historically been attractive to investors because of its supposed inflation protection characteristics.
The past three years have gone to show this asset class simply has not performed in the way that it should. We have since reduced our allocation to real estate and we are continuing to evaluate its purpose in the fund going forward.

You mentioned earlier the benefits that ESG brings to your portfolio. What is your ESG approach and how important is it to the fund?
ESG underpins all of our decisions, as it does for most institutional investors. It's generally about being future proof.
You don't want to be holding a bunch of assets today that have no buyer or value in the future. Our liability duration extends beyond 2050. So these are important and real considerations for the fund's performance and are not just arbitrary pen and paper models. This is also a hugely complex and multi-faceted area.

What do you make of recent negative headlines about ESG?
There's a lot of headlines out there and a lot of them are not so friendly to the investment management community in general.

Do you have a divestment policy within your ESG approach, or do you see engagement as a better way to address such issues?
We have exclusions, clauses in our pooled global equities fund allocation: that's

exclusions from extractive fossil fuel companies. We also have exclusions from investments in Russia – that is a reaction to the events over the past couple of years. But generally speaking, other than those two, engagement is viewed as the preferred and positive way forward. You can engage with the company to try to get them to change their behavior and this underpins our responsible investment policy.

The way I see it is if you divest, you encourage companies to go private, and then they can just continue that behavior behind closed doors with less scrutiny. Thus, engagement is almost always preferred.

Is your fund committed to net zero?

We haven't made an asset owner commitment to net zero. But our pool [Local Pensions Partnership Investments], with which we've pooled almost 100% of our assets, have made the Institutional Investors Group on Climate Change asset manager commitment to net zero and we fully support that.

So you have pooled almost all of your assets?

It's around 80% of our assets which are in the pool's investment vehicles. The remaining assets are managed by Local Pensions Partnership Investments. In the industry, pooling is interpreted in different ways. But we have fully embraced the government's pooling agenda from the early days.

> **Generally, our performance has been held back by our exposure to real estate.**

Our relationship with Local Pensions Partnership Investments, especially through the delegating of the manager selection process, gives us significant time to focus on the more strategic priorities to build resilience and improve our funding position and tackle other pertinent matters.

So pooling has proven to be a good initiative?

It has absolutely been the best thing that's ever happened to the LGPS in my opinion. The industry has seen quite a lot of questionable decisions in the past, perhaps being made by a few mavericks without proper diligence, scrutiny and challenge. That damaged performance, inflated fees, and, in some circumstances, actually influenced the LGPS' reputation.

It's crystal clear that putting qualified and experienced FCA-regulated managers in the decision seat is the absolute best thing from a governance standpoint for the LGPS and the asset management industry as a whole.

What has been your biggest challenge as a pension fund manager?

The biggest challenge has not been on the investment side of things but managing an increasingly complex administration environment within the context of diminishing and constrained resources and a skills shortage across the industry.

But probably the biggest challenge is working out where to go now in respect of climate change modeling.

There's a huge divide between the scientific community and the investment management community, and we are in limbo trying to work out what to do next with that. There is so much new data, so many new studies, so many headlines, to the point where we are working through all that right now. It's an incredibly difficult challenge.

On that modeling, what is the best way forward?

That's what we haven't quite established yet. We have done our modeling, but the whole LGPS and asset management industry in general is in limbo on what to do next.

DAMIEN PANTLING'S CV

September 2021 – present
Head of pension fund
Berkshire Pension Fund

February 2020 – August 2021
Head of finance (Growth, housing, corporate services, assurance)
London Borough of Barnet

2019 – 2020
Various local authority regeneration / property / commercial / trading company roles

2018
Pension fund manager
Westminster City Council

2014 – 2018
Various local authority finance roles

You mentioned resources and skills: what is the big issue?

This is more on the fund administration side. And there needs to be a two-step approach to this: one, getting people interested in pensions administration.

Secondly, grow your own. Recruit people at a graduate and apprentice level, train them up and ensure they have the appropriate skills.

What is the aim of the fund going forward?

The main aim of the fund is, and always should be, to pay pensions as they fall due.

What is your ambition as the pension fund's manager?

My primary goal is to get Berkshire back to full funding.

How long do you anticipate it taking until you achieve that?

It depends, because we value our fund every three years and the timescale changes. But the absolute latest would be 2038 based on current deficit recovery plans.

In unpredictable times, could hedge funds provide institutional investors with much needed certainty? *Andrew Holt* reports.

HEDGE FUNDS: TO THE RESCUE

Hedge funds have traditionally promised to give investors an edge. Yet in this uncertain investment environment, the appeal of the asset class has taken another turn – one that potentially offers a great deal more promise.

When markets are unpredictable and the macro-economic picture is uncertain, hedge funds tend to offer a defensive investor backstop.

The investment case is also supported by history. This is within the context that for most of the past decade, the hedge fund industry struggled to generate alpha, as low volatility led to fewer trading opportunities while near-zero interest rates hindered the asset price discovery process.

But then came the tightening of monetary policies, which have created a macro environment characterised by greater volatility – which should (and the emphasis is on "should") lead to better investing opportunities for hedge funds. That is to say historically, when equity and fixed income volatility increases, hedge fund alpha generation also improves. This scenario, keen investors will note, occurred last year.

Inflation's friend

So the hedge fund industry has displayed a positive relationship between higher inflation and higher interest rate regimes with better hedge fund performance, according to research by Goldman Sachs.

Furthermore, during times of low inflation, hedge funds have generated absolute returns that are around half (52%) of those available to equity investors. But in periods of high inflation, hedge funds have materially exceeded US equity market returns, based on the same research. The lessons are clear here, and evident of where we are now.

Another factor in favour of hedge funds is the breaking of the traditional stock-bond correlation. This has some investors concerned that it will limit the traditional foundations the correlation is built upon, creating an obvious opportunity for hedge funds to fill the gap.

Meisan Lim, managing director of hedge fund research at Cambridge Associates, says the current environment is ideal for hedge funds. "More than at any time in recent history, both equities and bonds have been sensitive to macro events, particularly to inflation prints," she says. "During periods of large positive US inflation surprises, macro hedge funds have tended to do better than a typical 60/40 portfolio.

"Conversely, when inflation has surprised materially to the downside, these managers have underperformed 60/40, though still managed to generate positive returns," she adds.

In addition, Patrick Ghali, managing partner at Sussex Partners, gives a nod to the fact that hedge funds appeal in the current environment, but with an added variation. "Institutional investors usually value more predictable return streams with less volatility, but not all of them want to have a large exposure to private assets. Hedge funds provide that type of return stream while still being liquid and without questions over valuations – as can be the case with private assets."

Additionally, Ghali says, hedge funds can provide low correlation or "defensive characteristics" to support the overall portfolio in times of stress. It was this defensive/low correlation that was extremely attractive to investors in 2022, given the chaotic market environment.

A different world

Ben Cooper, head of manager research at Cardano, the investment firm behind Now Pensions, says that diversification away from traditional asset classes, such as bonds or equities, is a key reason why investors turn to hedge funds. "Yet not all hedge fund strategies fill the gap created by the breaking of the traditional stock-bond correlation," he says.

Although he adds: "The term hedge fund is broad and encapsulates a range of strategies where diversification potential varies greatly," he says. "For example, we would expect a trend-following fund to offer a different return profile to a long-biased equity long/short fund over the medium to long term," Cooper says.

For all that though, he questions whether institutional investors are turning to hedge funds? "It's not clear cut," Cooper says. "And it is very much dependent on client type.

"A focus and preference for liquidity has suppressed some of the appetite for hedge funds, which can have fewer liquid terms," he adds.

Cooper says one trend he has observed is that investors who use hedge funds have increased their exposure to them. "In general, though, those that already have an allocation to hedge funds are generally more positive on the outlook for the segment, with the benefit of diversification as the main driver of this appetite," Cooper says.

Although Claire Lincoln, global head of institutional investor relationships at the World Gold Council, says the economic picture is a big spur for investors to turn towards hedge funds. "With recession risk still on the table, further bumps in the road ahead cannot be ruled out and investors may look to increase hedging and/or defensive strategies," she says.

> **While short-term performance tends to be head turning, it often isn't that informative.**
>
> Patrick Ghali, Sussex Partners

Cooper adds that there are other reasons for investors to consider getting into hedge funds. "In addition to their potential to offer differentiated returns from traditional asset classes, hedge funds also have the potential to improve: one, risk/adjusted performance; and two, downside protection of a portfolio."

The price of growth

Despite the attractions of hedge funds, the long shadow presented by high fees has frequently been a sticking point for investors. "High fee loads remain a challenge for certain investors," Cooper says.

The fees issue reared its head in an Alternative Investment Management Association (AIMA) investor survey. The key point it revealed was that investors are increasingly making a high level of transparency around fees and expenses a pre-requisite to any allocation.

The report asserts that hedge fund managers and investors are continuing to explore more "equitable compensation arrangements which meet their expectations". This potentially suggests a power shift in favour of investors, with more varied and better fee models being offered by many hedge funds to investors.

AIMA's research also showed that North America had reclaimed the title of the most confident region for hedge funds, having trailed the UK for seven consecutive quarters. The reshuffle reflects resilience among North American fund managers, AIMA says, and could be a useful guide for investors wanting to bring a hedge fund on board.

And investors have gone big on hedge funds – at least when measured by those funds reporting to Aurum's Hedge Fund Data Engine – which have grown by $35.3bn (£28.4bn) since the end of 2022 to stand at $2.9trn (£2.3trn). This was driven by net positive performance of $79.4bn (£64.1bn), which was partially offset by net outflows of $44.1bn (£35.6bn).

Seven of the eight master hedge fund strategies saw growth in assets under management, led by multi-strategy funds and followed by equity long-short vehicles. Multi-strategy fund growth was driven primarily by positive performance and modest capital inflows.

Where to look

But while hedge funds could well offer something for institutional investors, given the vast nature of the hedge fund universe, where should institutional investors be looking? Investors often cite finding the right hedge fund, at least those unfamiliar with the hedge fund world, as something akin to finding a needle in a haystack.

"We continue to favour strategies such as global macro and CTAs [commodity trading advisers] as well as relative value strategies," says Ghali, offering an insider's guide. He cites these being attractive due to "their non-correlated profile" and the fact that they are able to provide protection in challenging markets such as last year.

"Should we end up in a sustained, long-term bull market, models should be also able to adapt to this," he adds. However, Ghali also notes: "We are cautiously positioned and as such want some protection in our portfolios as we think there are a lot of risks on the horizon."

Although it should be noted that CTAs have had much publicised difficulties. To this, Ghali counters: "While 2023 has been challenging for some, but by no means all CTAs – we have some that are up 7% this year – we tend not to look at short-term performance but rather act like investors and not traders."

And he adds: "It is hard to judge any strategy on a few months of returns. While short-term performance tends to be head turning, it often isn't that informative."

Ghali also discusses the type of strategies that interest him: "We also are looking for strategies that are cash efficient and hence can benefit from the tailwind of higher rates on their unencumbered cash positions."

Cooper has an enthusiasm for global macro in his hedge fund wish-list. "Multi-manager platforms and global macro strategies have generally attracted inflows and have tended to perform strongly over the medium term," he says.

However, Cooper adds: "Within these strategies there is a scarcity of supply of high-quality managers. Larger, more established funds, with good track records, are able to secure more favourable economics and terms."

On trend

Global macro is attractive for several reasons. But the key one is if the trend toward what is often termed de-globalisation continues, there is a belief that individual economies will become less connected, and monetary and fiscal policies naturally will follow. This could lead to greater dispersion in the performance of asset classes globally – a hugely rewarding backdrop for global macro managers.

But the economic environment is changing. This potentially could see the environment move away from that attractive picture for hedge funds. After the high inflation experienced in 2022, is the case for macro hedge funds still intact?

"We believe so," Meisan Lim says. "First, we suspect risks are skewed to either matching or exceeding current inflation expectations," she says. "As a group, macro funds have a wide range of resources to identify mis-pricing and can choose from a variety of instruments to maximise their payout."

Lim notes other tailwinds support the thesis that a macro strategy will do well in an environment susceptible to inflation surprises. "Rather than focusing on promoting maximum employment as it did in the low-inflation era, the Federal Reserve is now forced to favour combating inflation by raising the Fed funds rate," she says.

Furthermore, Lim adds that when quantitative easing flushed the markets with liquidity and drove investors to reach for yields higher up the risk curve, concentrated beta-driven portfolios were more attractive than a diversified portfolio with many alpha sources. "Now that monetary tightening is in effect and interest rates have risen, macro managers are in an opportune position to benefit from greater alpha opportunities and diversification of assets and geographies," she says.

So the message is clear: institutional investors should be looking towards hedge funds to help boost and diversify their portfolio.

Not all hedge fund strategies fill the gap created by the breaking of the traditional stock-bond correlation.

Ben Cooper, Cardano

THE US: AMERICAN BYE?

The US appears to be in turmoil, politically and economically, leading some to question if it is still exceptional. But all is not lost for investors, says *Andrew Holt*.

The US faces unprecedented uncertainty. Take the political picture. Come November next year Donald Trump could return to the White House, or, he could be in jail. That is a stark and truly unparalleled difference.

Then there is the economy. The US economic outlook has continually shifted. In chronological order, the outlook has gone from soft landing to hard landing, no landing, crash landing, hard landing and now, it seems, a soft landing again.

But then there are added twists: such as the time lags between the Fed's aggressive rate hikes and the impact on the economy. With some suggesting the US could yet tip into a recession. This makes the US outlook unpredictable to say the least.

That said, indications suggest third quarter growth is doing nicely, thank you very much. Hardly putting the US on the precipice of a recession, but it is adding to the uncertain picture.

What are investors to make of it all? Let's take the political charade first.

Will the Trump and Biden show have an impact on investors?

Jack Janasiewicz, lead portfolio strategist at Natixis Investment Managers, is unperturbed. "It's challenging to opine on markets this far out ahead of a presidential election. The obvious issue is we don't know who the candidates will be and what their agenda will look like," he says.

The big fight

Indeed, while a straight fight off between Biden and Trump is expected, it is not inevitable. Given that while the incumbent president, Joe Biden, will seek re-election, there is the potential for health issues preventing this from happening. In particular, his embarrassing gaffes have become a daily occurrence.

Then running against him, the Republican nominee, based on polling, will be Donald Trump. But on-going legal troubles continue to cloud this backdrop. It may prevent him from accepting the Republican nomination.

If this ends up being the case, the American political system could go into meltdown, given the strong support Trump maintains through a proportion of the American population.

Richard Tomlinson, chief investment officer at Local Pensions Partnership Investments, ponders what it could mean from a geopolitics perspective if Trump was to return to the White House next year. "There will be challenges, for sure," he says. "How might this impact the China-America relationship? What impact could that have on investment opportunities?"

It is worth remembering that when Trump won the presidency in 2016, the S&P500 jumped by 12%. In recent history, the biggest fillip to the S&P by a presidential election was when Bill Clinton won his second term in 1996, which resulted in a 23% boost. The worst came when Barack Obama was elected president for the first time in 2008, which resulted in a dramatic drop of 37%, according to Morningstar.

Winners and losers

When it comes to the run up to the election itself, it poses negatives and positives for Tomlinson. "The election creates problems and opportunities," he says. "Governments and politics

> **Never underestimate the flexibility and dynamism of corporate America and the US economy.**
>
> Jack Janasiewicz, Natixis Investment Managers

are now defining investment winners and losers, in terms of sectors, and particularly in green energy."

Although some of the pre-election fervour can be attributed to nothing more than political noise – albeit with the volume turned up to maximum – which may not necessarily shape the nature of the markets.

In addition, the positive US outlook, based on a soft landing, and the fundamentals in the economy suggest the country overcoming its recent difficulties. A point made by Raffaele Savi, head of systematic equity at Blackrock. "So far in 2023, equity markets have shrugged off banking stress, recession risk and monetary tightening in favour of a more optimistic view," he says.

So on this basis, if it was a road trip, the US economy has overcome some big bumps in the road, but now a clear route has opened up ahead. One like Route 66, clear and enjoyable.

Janasiewicz concurs on such a scenario. "We remain in the soft landing camp based on our current economic outlook. This leads us to favour risk-on assets, preferring equities over bonds and the US relative to the rest of the world," he says.

One assessment says the soft landing scenario is already evident in the data. Goldman Sachs suggests US equity cyclical stocks have outperformed defensive stocks by almost 12% across June, July and August. Goldman Sachs says the equity markets are, therefore, predicting 2% GDP growth this year as a result.

Hard to ignore

This is a source of debate. "The US economy continues to evolve," Tomlinson says. "The next three to six months are hard to call."

But Tomlinson adds that from an institutional investor perspective, especially with a long-term timeframe, it is difficult to ignore the US. "We have significant exposure to US equities. It is hard not to have a meaningful exposure to the US. If you don't, you will be way off the benchmark."

There is no doubt that the US equity market is in a good place. But this is unlikely to last, says Aron Pataki, co-head of real returns at Newton Investment Management. "The US equity market could continue, but if history is a good guide, and I think it is, then returns are going to be subdued, poor in the medium term from here. Because interest rates are high and valuations are elevated," he says.

This presents its own uncertain view for investors, without the added complexity created by the election and all its shenanigans.

Janasiewicz says we can though highlight some observations in reference to US presidential elections from history about the shape of markets to come. "The first being that markets, from a seasonality perspective, tend to rally several months into the heart of the election campaign," he says.

Here Janasiewicz highlights that July through to September have historically been strong months for the stock market in election years, ultimately giving way to some weakness up until election day, and then finally resuming an upward trend.

He also sees similar seasonal patterns in implied volatility for equity markets, with a notable uptick in volatility beginning in September and rising through election day and then finally seeing pressures abate into the end of the year.

But given the unique and potentially divisive nature of the election ahead do historical precedents still stand?

Congress is king

Although another factor in not getting too carried away about the political situation impeding on the market is that presidential elections tend to have a limited impact on the direction of the markets given that Congress 'controls the purse strings,' Janasiewicz says.

And he adds that again looking at historical return patterns, markets do best under a Democratic presidency accompanied by a split Congress while a Republican president with a split congress has less robust outcomes.

"And while a Democratic-led Washington tends to see higher stock market returns, what matters most is the economic backdrop," Janasiewicz says. "By far and away, earnings growth matters more so than the political landscape."

And as the mantra goes – once you give corporate America the rules by which they must play, they'll figure out how to make money. "Never underestimate the flexibility and dynamism of corporate America and the US economy," Janasiewicz says.

Big checks

Another factor tending towards calm is that while the political climate in the US has become increasingly more polarized over the years, the system of checks and balances central to the

US political system has prevailed. Although they have been severely tested at times.
It is this system of checks and balances that prevent a significant deviation from current polices that can upset the apple cart from an economic perspective and create real uncertainty for investors.
"Sure, we have seen the power of fiscal spending more recently but monetary policy still remains largely independent, despite what some may argue," Janasiewicz says.
Although how much fiscal latitude Washington has going forward given that the deficit has been a hot button issue will remain critical. "How the economy evolves from now until election day will be key in terms of opportunities or challenges towards investing," Janasiewicz says.
He adds that he doesn't expect much to change in terms of economic drivers from the US political backdrop in the run-up to the election next year. "Rather, chair Powell and the Fed are the more important inputs. Inflation, the labour market and growth prospects all carry a far heavier weight than the debates or polling."

Campaigning hot air

Putting some numbers to the impact of US elections on the market, it is interesting to note that there have been 23 elections since the S&P500 began. In these election years: 19 of them (83%) provided a positive performance. Which bodes well for investors.
When a Democrat was in office and a new Democrat was elected, the total return for the year averaged 11%. When a Democrat was in office and a Republican was elected, the total return for the year averaged 12.9%. Based on these numbers, investors have little to fear.

So far in 2023, equity markets have shrugged off banking stress, recession risk and monetary tightening in favour of a more optimistic view.

Raffaele Savi, Blackrock

Another issue to consider in the run up to election is the nature of political campaigning itself and its overall impact. Campaigns almost always increase the noise leading up to an election: it is its job after all.
But the noise often outweighs the substance, with candidates frequently outlining in their stumping policies that often get watered down or sometimes lost, but rarely get implemented as promised. So the concern for markets the debates often throw up can be dismissed frequently as hyperbole.
Janasiewicz defines the real players in the US political environment. "The president and Congress can certainly help in providing a fertile background in which businesses operate. But aside from this, the impact is somewhat muted," he says. "The economy matters more and the political backdrop has far less of influence here than most give credit."
Here we return to the favourite maxim of Bill Clinton's adviser James Carville: It's the economy stupid.

Exceptional America

There could also be another explanation for what is happening in the US. Richard Tomlinson puts the potential parlous position of America in a wider perspective. "It is about America exceptionalism. It is about one question: Is America still exceptional?"
This puts into question America's position in the world, one where it could well be no longer the hegemonic political and economic kingmaker: a position it has held since the Second World War. This has implications far beyond the 2024 US presidential election.
"Some are saying the era of America exceptionalism is coming to an end. But there are pretty good reasons why that is not the case," Tomlinson says. "Being the world's dominant reserve currency gives you a massive privilege. The US is also still the major superpower. Until that changes, America will remain appealing as a relatively stable and dynamic market."
It is true that, despite all the noise surrounding the election, the US market is hardly in decline. This is seen through the so-called 'super-7' US stocks: Apple, Microsoft, artificial intelligence specialist Nvidia, Amazon, Meta, Tesla and Alphabet, which now make up more of the global equity index (MSCI ACWI) than the whole stock markets of Japan, the UK, China and France combined. That screams strength not weakness.
Bringing all arguments back to the market, Tomlinson offers a straightforward and balanced assessment to the impact of the US election and its position in the world as the leading nation.
"If you look at some US stocks, it maybe does look ominous in some areas. And the US does face some significant challenges. There is no doubt about that," Tomlinson says. "But we are not seeing the end of America anytime soon."

pi ESG CLUB

Debt will play a crucial role in the world transitioning to a regenerative economy from one powered by oil and gas. This month, we look at how institutional investors are making their debt portfolios more sustainable.

Members

AON

BlackRock

BNP PARIBAS ASSET MANAGEMENT

JUPITER ASSET MANAGEMENT

LGIM

M&G Investments

NEWTON Investment Management

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

SUSTAINABILITY
MEANS
INVESTING

FOR
REAL-WORLD
CHANGE.

NEWTON
Investment
Management

Invest with purpose

newtonim.com

BNY MELLON | INVESTMENT MANAGEMENT

Your capital may be at risk. The value of investments and the income from them can fall as well as rise and investors may not get back the original amount invested.

This is a financial promotion. Issued in the UK by Newton Investment Management Limited, The Bank of New York Mellon Centre, 160 Queen Victoria Street, London, EC4V 4LA. Registered in England No. 01371973. Newton Investment Management is authorised and regulated by the Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN and is a subsidiary of The Bank of New York Mellon Corporation.

NEW FRAMEWORK AIMS TO PUSH FINANCE AND BIODIVERSITY CLOSER TOGETHER

The TNFD wants to shift the dial on nature-related risk through improving reporting and boosting financial flows, finds *Andrew Holt*.

After two years of discussion, The Taskforce on Nature-related Financial Disclosures (TNFD) has published its final recommendations for a nature-related disclosures framework – a move which is likely to have big implications for institutional investors.

The TNFD has two aims: to inform better decision making by companies and investors; and contribute to a shift in global financial flows toward nature-positive outcomes.

The initiative has strong support. It is led by 40 members which collectively have more than $20trn (£16trn) of assets under management. It also has the support of stakeholders from almost 60 countries.

The introduction of the TNFD's 14 disclosures, along with its implementation guidance, comes at a time of rapidly growing global interest in nature and biodiversity issues.

Policymakers, regulators, asset owners, investment managers and corporates are, as witnessed at events hosted by *portfolio institutional*, particularly our ESG Club Conference in September, increasing their focus on nature-related risks.

A big and vitally important factor within that is the necessity of mobilising finance to tackle nature loss and scale-up nature-based strategies.

The costs of inaction

The TFND's recommendations build on those of the Task Force on Climate-related Financial Disclosures (TCFD). They are also "consistent with the global sustainability standards of the International Sustainability Standards Board" and the "impact materiality" approach used by the Global Reporting Initiative and incorporated into the European Sustainability Reporting Standards.

This, says the TNFD, provides organisations with nature-related guidance that enables their reporting requirements across jurisdictions with the different approaches to materiality now in use.

On the impetus behind the disclosures and framework, David Craig, co-chair of the TNFD, said: "Nature loss is accelerating, and businesses today are inadequately accounting for nature-related dependencies, impacts, risks and opportunities.

"Nature-risk is sitting in company cashflows and capital portfolios today," he adds. "The costs of inaction are mounting quickly. Businesses and financial institutions now have the tools they need to take action."

Emma Latham-Jones, senior manager at responsible investment campaigner Share Action, applauded the initiative. "The new TNFD framework is a crucial step in the right direction towards protecting our planet's nature and biodiversity."

She does, though, have some concerns. "Chief among them is the lack of data standardisation that would allow information about biodiversity to be compared effectively between financial institutions," Latham-Jones said.

"We urge the business and finance sectors to incorporate the new framework into their decision-making process," she added.

Aligned reporting

The TNFD recommendations align with the requirement of Target 15 of the Global Biodiversity Framework for corporate reporting, which calls for assessment and disclosure of nature-related risks, impacts and dependencies. This would enable companies to align their corporate reporting with global policy goals, as they are doing on climate-related issues.

Following the example of the TCFD, the TNFD will track voluntary market adoption annually through a status update report beginning next year.

David Willans, sustainability director at corporate communications consultancy Bladonmore, has been following the issue with interest and believes the outcome is positive. "The guidelines do the herculean task of setting out how to understand the relationship between nature and a business. This gives communicators the facts to communicate in engaging ways, over and above ticking the disclosure boxes," he said.

Echoing a similar point, Elizabeth Mrema, co-chair of the TNFD, highlighted how nature-related risk management has risen up the ladder of importance for investors. "Business as usual is no longer an option and business and finance can no longer consider nature and biodiversity as just a corporate social responsibility issue. It is now squarely a central and strategic risk management issue," she said.

Fast evolving

But Willans added that challenges remain. "Corporates and investors alike have to recognise that this is an entirely new, fast-evolving field. Smart investors will. And they will expect companies to be transparent about what's not yet been done as much as what has. For some companies that's going to be hard because they're worried about the optics, but not doing it carries much greater risks," he said.

Pharmaceutical behemoth GSK has been first to rise to the challenge. It is to publish its first TNFD disclosures from 2026, based on 2025 data. TNFD expects other companies to follow its lead. The TNFD also plans to announce an inaugural list of its adopters – companies that have indicated their intention to start adopting the recommendations – at the World Economic Forum at Davos in January.

THE MEMBER BACKING PENSIONS AND LIFETIME SAVINGS ASSOCIATION

ANNUAL CONFERENCE 2023

ANNUAL CONFERENCE 2023

17 - 19 OCTOBER
MANCHESTER

THE DEFINITIVE PENSIONS CONFERENCE AND EXHIBITION, WHERE THE INDUSTRY COMES TOGETHER TO DISCUSS EVERY ASPECT OF PENSIONS, FROM COMMUNICATIONS AND ENGAGEMENT, TO INVESTMENT, TO THE GEOPOLITICAL OUTLOOK, AND THE TRUSTEE AGENDA.

Join us at the UK's biggest pensions conference as we celebrate 100 years as the voice of workplace pensions.

Find out more at
plsa.co.uk/annual-conference

FREE FOR PLSA FUND AND MASTER TRUST MEMBERS

INTERVIEW – DAN NEALE

"Investors should not see themselves as separate from society."

The responsible investment social themes lead at the Church Commissioners for England sits down with *Andrew Holt* to discuss the challenges of promoting the social aspects of ESG, waving goodbye to oil and gas, pushing human rights and the importance of having a plan.

What does the role of social themes lead entail?

Within the investment division, I look at social issues in the Church Commissioners' portfolio. I look at human rights, slavery, ethics, the just transition and ethical screening – and that covers all asset classes.

The role of social themes lead is a new position: why was it created?

I joined in April last year when the Church Commissioners decided to bring in more thematic specialists. This reflected a strategy change within the organisation away from having generalists to a focus on specialists in particular areas.

Why is the social aspect so important to the Church Commissioners?

At the highest level, the Church of England's Marks of Mission include addressing social structures and social issues. Our role as an ethical investor is plugged into those social structures.

The social aspect should be equally important to all investors because fundamentally, investors are part of society. They are impacted by it; they are not separate from it.

That is an important part of the ESG debate: investors should not see themselves as separate from society. And our belief is that socially responsible conduct underpins value creation and supports long-term returns.

A good point. Do you think, therefore, that the S in ESG gets neglected by investors in favour of the E?

Neglected is a little strong, but the S has been a poor cousin to the E. Although if we go back to when responsible investment and ethical investing was new, a lot of it was people focused. It was about avoiding products that were inherently harmful, like tobacco. We don't invest in those because they harm people. So there was a starting point with a heavy S as a focus in investment.

The rise of sustainability led to a heavy focus on the E, particularly climate issues. That then received a lot of traction.

In part, it reflects that many investors got behind the idea of climate change as a systemic risk. The setting up of frameworks – like the Task Force on Climate-related Financial Disclosures – came with all that and it was driven forward.

There is also an argument that the numbers within the E are easier to wrap your head around, such as the targets. Whereas the S can mean different things to different people.

Is that why the social part doesn't get the focus it should?

There are always going to be trade-offs in terms of resources and what to focus on. Seeing what has happened in the past few years, particularly between Covid and social movements in North America, has helped push the S higher up the agenda.

But it is steeped in inclusion in some cases. And that doesn't necessarily trans-

late into all parts of the world having the same point of focus. There is a certain element of being conceptual with the different topics.

Like with net zero in the E, there isn't that identifiable equivalent that everyone can pile into and push forward on within the S. So it isn't, coming back to the initial point, that the S hasn't been neglected as such, it is in fact more disparate across a lot of different topics.

So, therefore, does a net zero equivalent need to be created on the social front?

We want companies to respect human rights and we recognise social inequalities as a systemic risk. We want companies to address social inequality or at least not become entrenched within it.

And on those two things, it is unfortunately something that companies don't coalesce around. There is no net positive on the social side because you cannot offset human harms here by doing good stuff over there.

How does your responsible investment approach work overall?

We are quite open about our responsible investment approach, which is set out by our RI and ethical policies. Our framework is to respect people and the planet. It is big and, as it is not either/or, relates to our increased positives and negatives in dealing with those risks.

The systemic risks we have focused on will guide our stewardship work on three levels: climate change, nature loss and social inequality. They also feed into the practical work as to where we should invest.

And then there is the micro level, where we actually engage with assets and individual companies. And also on the manager level, where we integrate responsible investment into our manager selection so they improve and go higher up that level of responsible practices.

Then there is the macro level, where we look at the big picture stuff – the environment in which businesses operate in. So that is how we translate the policy into a practical approach.

You are guided by the Charity Commission's rules: do they hamper your ESG ambitions?

We are not an impact-first investor. The Charity Commission's rules set out quite clearly that our charitable objectives are to supply sustainable returns to the Church. So that gives us nice clear parameters.

Just because we cannot do concessionary investing it doesn't mean we cannot have a positive impact at the same time.

They hamper us in that respect – because it comes down to the objectives of the organisation. There is a box we are in within the rules and it is how do we do the best within that box to achieve what we want to achieve. For example, we had a green bond launch, which fed into the sustainability investments. So there is plenty like that we can do. There is a vast amount of impact that charity investors can have.

The Church Commissioners have committed to divesting from fossil fuel companies which are not aligned with the Paris Agreement goals. Where are you with these plans?

Back in 2021, we excluded 20 oil and gas majors from our investment portfolio. We are now excluding BP, Ecopetrol, Eni, Equinor, Exxon Mobil, Occidental Petroleum, Pemex, Repsol, Sasol, Shell and Total, after concluding that none of them are aligned with the goals of the Paris Climate Agreement, as assessed by the Transition Pathway Initiative.

The broader exclusion of all oil and gas exploration, production and refining companies will follow by the end of 2023. The decision to disinvest was not taken lightly. Alan Smith [First Church Estates Commissioner] has said on the issue that the energy majors have not listened to the voices in society or markets they serve and they are not moving quickly enough on the transition.

Last year you made a commitment to vote against companies that do not meet expectations on human rights. Why is this important?

It comes back to having respect for the people. On a human rights policy, we expect all companies to respect human rights. That is a fundamental expectation. And it underpins other social themes like decent work, just transition and artificial intelligence ethics.

We also recognise, as I have said, social inequality is a systemic risk, which can create a risk to investors like us. The Business Commission attacked inequality, and we agree with their view that at the heart of that risk is how companies respect human rights.

So it brings together our ethical thinking and our long-term systemic risk thinking. It is about how we take that systematic approach.

Would you divest from a company over this issue as a result?

What we are looking at is whether they have policy commitments to respect human rights and whether they implement due diligence. These topics are well aligned to the legislative requirements. It is a good hook to engage with companies. It is not really a disinvestment conversation. But if there are breaches of human rights, that is then a different conversation.

The Church Commissioners list the themes as Respect for People and Respect for the Planet. What do they mean?

As I mentioned, it is big and we look at where both come together: like a just transition for workers towards net zero, or respect for land and rights in addressing nature loss.

It gives us a focus area of the things we want to see. We have set out net-zero targets. It gives us the ability to say why we are talking about these topics and gives us a framework in which to bring all the things together. We are recruiting for a planet lead at the moment.

The S has been a poor cousin to the E.

Your experience is leading social and human rights rankings and impact at the World Benchmarking Alliance. Has your time as a social performance consultant and an officer in the Royal Navy served you well in your current role?

I hope so. I have had a wiggly career path. It is good to have a diverse experience coming into a role like this.

And there are some unrealistic expectations placed on the ESG stuff – to be experts across all of its issues. One of the Navy's defined traits is to be cheerful in adversity. That's useful when we have emerging dramas. Worse things have happened at sea. I bring that with me when it comes to emergencies or problems.

From the civil society piece, it is engaging with companies and understanding what engagement looks like. That has been useful.

What have been your biggest challenges in this role?

Moving into a different space. It has been learning about the Church Commissioners, as it is a complex organisation. It has a long and distinguished history and is a diverse investor. There has been a lot to learn. So the biggest challenge has been wrapping my head around it all.

What are your main priorities going forward and why?

One of them is the human rights voting approach. We are looking to publish a round up on this towards the end of the year. But we also recognise the lack of data on this. So we are in the grip of something for investors to engage with data providers on this topic. That is something we want to carry forward. We want to take systemic action, but we recognise the data is not yet available.

A broader priority is to bring all these disparate elements into an overarching social plan. This is so that we can have a social action plan close to that of a climate action plan.

Christophe Montcerisier is head of real estate debt at BNP Paribas Asset Management

EUROZONE COMMERCIAL REAL ESTATE RESET CREATES OPPORTUNITIES FOR DEBT INVESTORS

The sharp rise in interest rates over the last year has lowered valuations and led buyers to demand higher yields when acquiring commercial property. Banks have increased their scrutiny and caution, reducing loan-to-value funding ratios. While there is still demand from borrowers, especially for refinancing maturing debt, the amount of debt offered by banks per square metre is lower. We believe this environment presents an attractive opportunity for investors.

Real estate pricing

Currently, real estate prices are being reset. Property markets, including those for commercial real estate, are adjusting in the face of two opposing forces:

– On one hand, the significant rise in interest rates in the eurozone since the summer of 2022 has increased borrowing costs and is weighing on property valuations

– On the other hand, higher inflation is expected to boost rental revenues over time as rents are typically partly or fully indexed to the rate of inflation.

As a result, the amount of money you can now borrow from a lender has decreased (the maximum is circa 10 points less than a year ago), while returns have increased along with market interest rates (the coupon rate on the bonds is typically floating).

Vulnerable segments Interest rate rises have pushed up costs for property owners. Leveraged lenders may be vulnerable when asset price resets occur. Pessimists point to the lingering effects of the Covid-19 pandemic: consumers have not fully returned to shops and many workers are still working from home. These trends are undermining the value of shopping centres and offices, though more so in the US than in the eurozone. This is because the eurozone has not seen the property market excesses that will likely create problems in the US market in coming months. In the European CRE market, lower-grade office properties face both weakening demand and higher construction and maintenance costs. Potential buyers are retreating; lenders are imposing punitive lending rates; and occupiers are upgrading, leaving lower-grade properties and moving into buildings that meet the latest environmental standards.

WFH – less impact in the eurozone

The shift to working from home (WFH) during the pandemic triggered discussions about the impact on demand for office space and the damage it could do to the performance of office markets. News that financial firms are encouraging, or even requiring, staff to return full time to the office suggests the trend may have peaked, but we have not yet reached a new equilibrium. If working from home expands, it could significantly reduce demand for office space, resulting in higher vacancy rates, obsolescence and falling rents.

Anecdotal reports suggest offices in Europe have seen a much sharper post-Covid rebound in usage than in the US. The Wall Street Journal recently noted US office occupancy was at 40% to 60% of pre-Covid levels compared to 70% to 90% in Europe. Longer commutes, poorer public transport networks and larger suburban dwellings kept US commuters working from home. Tighter labour markets may also have led US firms to hire more remote workers in recent years.

While the commercial real estate market will undoubtedly face challenges in the years ahead, we believe the office sector remains a viable opportunity, particularly when considering the regional differences.

Risk of stranded assets due to ESG requirements

According to the World Green Building Council, buildings account for 39% of global energy- related CO_2 emissions. Around three-quarters of these emissions come from operating buildings, the rest from construction. New environmental regulations to address these issues have added significantly to the costs of upgrading a building from today's standards to 2030 requirements.

Owners of buildings outside city centres or in smaller towns may struggle to meet these obligations and these buildings may become stranded assets. This factor is already being integrated into the market's assessment of buildings and contributing to lower valuations.

While the requirement to upgrade or refurbish buildings to a higher standard is a challenge for property owners, it creates opportunities for those financing it.

For professional investors. BNP PARIBAS ASSET MANAGEMENT UK Limited, "the investment company", is authorised and regulated by the Financial Conduct Authority. Registered in England No: 02474627, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom. www.bnpparibas-am.co.uk This article is issued by the investment company. Investors considering subscribing for the financial instruments should read the most recent prospectus or Key Investor Information Document (KIID) available on the website. Opinions included in this article constitute the judgement of the investment company at the time specified and may be subject to change without notice. This article does not constitute or form part of an offer or invitation to subscribe for, underwrite or purchase an interest in any strategy. The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial investment. Past performance is not a guide to future performance.

Private assets are investment opportunities that are unavailable through public markets such as stock exchanges. They enable investors to directly profit from long-term investment themes and can provide access to specialist sectors or industries, such as infrastructure, real estate, private equity and other alternatives that are difficult to access through traditional means. Private assets do, however, require careful consideration, as they tend to have high minimum investment levels and may be complex and illiquid.

BNP PARIBAS ASSET MANAGEMENT

SUSTAINABLE DEBT: CLEAN MONEY

With the energy transition needing debt to succeed, how are institutional investors ensuring that their capital is being used to create a sustainable future? *Mark Dunne* reports.

Debt makes the world go round. It has built civilisations, funded technological and medical breakthroughs and kept armies stocked with the armaments that have changed the course of history.

Indeed, today the world's debt pile stands at $307trn (£251trn), a figure which jumped by $10trn in the first half of this year.

Lending money to corporates and governments has for centuries been used to change the world. And it is needed once again, but this time to fund the most ambitious project we have ever faced – shifting the world off oil and gas and into cleaner alternatives, while trying to make the world fairer.

It's not an easy task. Especially, when you read headlines claiming that it is too hot for solar panels to work or there's not enough wind in the North Sea to drive the turbines.

"Fixed-income markets are critical to funding the transition, as most of the funding will come from the debt markets, both

sovereign and corporate," says Scott Freedman, a fixed income portfolio manager at Newton Investment Management.

"This provides a growing number of opportunities for bond investors to help further the drive to achieve positive environmental and social objectives, even in an environment of several ESG headwinds," he adds.

Historically, sustainability has been promoted in equity portfolios. However, this is changing as investors and their stakeholders believe that such a policy should stretch to all the assets they have exposure to. And different asset classes need different approaches.

"Although a lot of focus has been on the equity side, there are a number of tools on the debt side to do this. And those tools are becoming more sophisticated," says Jonathan Lawrence, senior responsible investment analyst, active fixed income at Legal & General Investment Management (LGIM).

These include promoting decarbonisation and temperature-alignment pathways, while exclusions form a big part of how asset managers approach climate risk on the debt side.

"The other big tool, which is less appreciated, is engagement," Lawrence says. "It's important that we are engaging with companies in our debt portfolios to understand if they have a meaningful climate transition strategy in place."

Not what it says on the tin

But debt which is labelled sustainable is not an end in itself. "We shouldn't just look at a portfolio of sustainable debt and believe it is robust from a climate transition perspective," Lawrence says.

"What it does is signpost that issuers are potentially moving in a certain direction, but we need to look at issuers in their entirety and not just their labelled debt," he adds.

A portfolio of labelled debt cannot achieve net zero, Freedman says. "Labelled bonds, while an important and growing part of sustainable finance, must be considered on a case-by-case basis given greenwashing risks," he adds. "They may not always provide credible and robust initiatives and targets."

Many labelled bonds make furthering environmental objectives part of their framework, but other targets exist too, such as healthcare provision. "There is much more that needs to be done in order to try and achieve net zero, and shorter-term targets will be an important part of that," Freedman says.

Yet just because a company has not issued any green bonds does not mean it isn't mobilising capital into green projects. "That would be more important to consider than a brown issuer who uses a green bond to fund a small amount of capex," Lawrence says.

In the conventional debt market, engagement sets the expectations for companies in terms of their strategy and making sure robust governance and accountability is in place. "That's more important than the label on the bond," Lawrence says.

Different shades of green

But could a portfolio of sustainably labelled debt make an investor appear to be greener than they actually are?

"That's definitely a risk," Lawrence says. "The tension in the market has always been around governance and whether or not the barriers to entry should be higher to issue sustainably labelled debt without hindering efforts to mobilise capital towards green activities.

"LGIM's position has always been to focus the analysis at the issuer, not just the instrument, to make sure the bond, and the portfolio, reflect a genuine move towards the transition and not just a chance for greenwashing," he adds.

Freedman says that it is "likely" sustainable labels make portfolios appear greener than they truly are, and warns: "You need to analyse issuers on a case-by-case basis," he adds. "We need to be careful about label chasing."

> **We need to be careful about label chasing.**
>
> Scott Freedman, Newton Investment Management

With a limited supply of green bonds, the main option for institutional investors is to make mainstream debt more sustainable. "Issuers, both sovereign and corporate, are under much greater scrutiny in terms of behaving as responsible citizens," Freedman says. "This raises the level of granularity around sustainability initiatives that a broad range of stakeholders, including bond investors, expect to see.

"This introduces a greater level of accountability, a type of trust or covenant in place between issuers and investors. In turn, this leads to greater bondholder engagement, ESG analysis, tracking of ESG performance and will increasingly impact issuers' cost of capital, especially for 'sin' sectors," he adds.

A test of quality

Transparency on non-financial factors by issuers varies, Freedman says. "As you would expect, there is a greater level of disclosure by listed companies and those in jurisdictions with stricter regulatory regimes.

"We also see pressure on asset managers to make disclosures that are not always being provided by underlying issuers in portfolios," he adds.

Transparency on ESG performance is improving thanks to a "huge wave" of regulation, Lawrence says. "But we still have an issue with the consistency of reporting and the end-use case for the investor.

"Again, I would tie that back into the case for engagement where we need to understand the nuance and context of the business model and how a company plans to become more sustainable.

"Disclosure is necessary, but being an end in itself is not sufficient," he adds.

An independent view

With the standard of disclosure needing to improve, it was disappointing to hear in August that S&P would no longer report

ESG scores alongside its credit ratings. Could this be a sign of how hard it remains to prove that investors cash is making a positive difference? "I don't think so," Lawrence says. "That probably represents more of a misunderstanding of what ESG ratings are there to do.

"In the case of S&P, they are a credit rating agency and their decision to remove the ratings reflects their ability to translate ESG data into a material credit rating impact.

"What they have done is kept their qualitative analysis in terms of explaining where ESG risks could potentially impact the rating."

The bigger challenge is people's understanding of what ESG ratings are, how they're constructed and how to use them. For Lawrence, ESG ratings are a subjective analysis of how companies are managing sustainability risks and opportunities. "But where these ratings become hardwired into portfolios, then we need to take care with how the rating has been constructed, what is the methodology."

While such data can be useful, perhaps this is a positive move, in that the lack of consensus among providers could be confusing. Freedman says that such divergence among ESG rating providers mean that you cannot take such ratings seriously. "It is just part of the mosaic of information.

"We do not rely on data providers' methodology but on raw data, and then draw our own conclusions," he adds.

"The unfortunate thing about a conventional credit rating agency no longer reporting ESG scores alongside its debt ratings is the message this gives to issuers," Freedman says.

"Having that data published increases the level of scrutiny and accountability on issuers – and having a more explicit link between ESG factors and a conventional-credit rating does impact market pricing, thereby encouraging issuers to strive to be an ESG leader if it results in a possible lower cost of capital."

Disclosure is necessary, but being an end in itself is not sufficient.

Jonathan Lawrence, Legal & General Investment Management

Different worlds

For investors with sustainable goals, their debt portfolios must reflect them, matter who they are lending to. This includes corporates or sovereigns, which have similarities but offer investors different exposures.

First of all, the number of sovereigns is fixed, unlike in the corporate world, which is constantly changing. "We have a lot more information about the world's sovereigns and there's lots of ESG data that has existed for a long time. In a sense, measuring ESG risk for sovereigns is easier than for corporates," Lawrence says.

"Where it gets trickier for investors is on the engagement side. As a significant holder of sovereign debt, we are an important stakeholder to governments. We can therefore use this leverage to influence policymakers to address ESG risks and opportunities. However, there are challenges which can limit our influence, including structural features of the sovereign debt market."

And investors need to have influence over governments if they are using their money. "There are challenges and barriers that we need to overcome in the sovereign market with respect to what sovereigns are doing on the ESG side," Lawrence says.

Behind the rate

Have rising interest rates had an impact on the sustainable terms of debt? "Not really. Issuance looks quite robust," Lawrence says.

In September, labelled debt on the active side of LGIM's investment universe was about 8% of the index. In 2020, it was around 2% to 3%. "When issuers come to market, we are seeing a lot of momentum behind the labels. So, the macro conditions could play through in terms of issuance trends in general," Lawrence says. "But we are seeing a lot of appetite to use the labels on bonds, and increasingly, a greater breadth of issuers are coming to market with this form of debt."

However, Freedman says the volatility in the bond market resulting from the fast pace of rate hikes by central banks has led to a slower pace of sustainable and broader bond issuance.

"As we have seen lately, there is a gradual realisation amongst companies and governments that decarbonisation ambitions are important but not at any cost," Freedman says. "We are seeing timeframes therefore extend and policy-backtrack from governments. The cost of achieving the transition has been increasing not only due to higher funding costs from higher rates, but also from persistently higher inflation. Within this is more acceptance of the need for climate adaptation as well as mitigation."

When it comes to lending your capital to corporates or governments, the important point is that it is not about where they are today, but where the capital they receive will take them.

Duncan Batty and Dan Riches are directors of real estate finance at M&G Investments.

ESG IN REAL ESTATE DEBT: FUNDING THE TRANSITION TO NET ZERO?

Recent turmoil in the banking sector has further highlighted the role real estate lenders can play by stepping in to provide capital for borrowers as banks retreat, while potentially delivering a stable, long-term source of income. With many lenders now gravitating towards high quality assets with strong ESG credentials, we consider what role real estate debt can play in funding the transition to net zero.

The built environment is responsible for around a third of global emissions, the majority of which stem from building operations[1]. As momentum behind sustainability in real estate continues to gain pace, lenders can play a key role in how the sector evolves as it strives to meet net zero goals.

In the EU, where almost 75% of building stock is energy inefficient, real estate is the single largest energy consumer, with heating, cooling and domestic hot water accounting for 80% of the energy consumed by citizens[2]. The European Parliament adopted measures earlier this year to reduce real estate energy consumption and greenhouse gas emissions, while increasing the rate of renovations to improve existing standards[3]. Currently only 1% of existing buildings in Europe are renovated each year. New developments will have to be carbon neutral from 2028 onwards.

> **Substantial renovations are necessary across geographies to improve existing real estate stock and reduce energy loss.**

In the UK, real estate accounts for 40% of total energy use and around a third of emissions[4]. The government has laid down ambitious plans designed to spur a 'green revolution' in real estate, requiring all homes and businesses to meet rigorous targets in order to lower energy consumption. Indeed, policies are already obliging developers, landlords and occupiers to focus on the environmental performance of buildings.

Addressing energy efficiency in real estate

Regulations setting out Minimum Energy Efficiency Standards (MEES) are making it increasingly unlawful to rent properties that do not meet the Minimum Energy Performance Certificate (EPC) requirements, bar some exemptions, with landlords facing serious sanctions for non-compliance. This means lenders will also have to navigate the changing regulatory landscape and consider ESG criteria when deploying capital.

Currently, non-domestic buildings in England and Wales need an EPC rating of E or higher to be viable for lease. From April 2030, rented properties will be required to have at least a B rating. This poses a significant challenge for the real estate sector given that the vast majority of existing commercial stock in England and Wales – around 64% – falls below the B threshold for energy performance[5]. In real terms, over half a million individual assets need to be compliant with MEES within the next seven years[6].

In Europe, a set of standards and accompanying technical reports have been established to support the energy performance of buildings standards, with the European Commission aiming to reach the target of at least a 60% reduction in emissions in the building sector by 2030 compared to 2015, and achieve climate neutrality by 2050.

Although there is little guidance on the level of capital required to decarbonise non-domestic assets, it will be a costly endeavour. Substantial renovations are necessary across geographies to improve existing real estate stock and reduce energy loss, while new developments would have to consider smart solutions and energy efficient materials to ensure buildings are compliant with net zero goals and regulation.

Funding the transition

Real estate debt investors could be crucial in helping fund the transition to net zero in real estate due to the levels of investment called for, but it is essential for lenders to have a solid understanding of how energy is used in buildings and what measures can be taken to reduce emissions and energy consumption in line with science-based targets. There are challenges, particularly where there is a lack of consistent data and reporting among borrowers, as well as a disconnect between some sustainability metrics and a lack of definition regarding what net zero actually means across the industry.

To play a role in the transition to net zero, lenders may want to consider improving the environmental performance of real assets over time, while also excluding investments which are considered harmful to the environment or society, such as assets which are involved in the extraction and storage of fossil fuels.

For sustainability-conscious lenders, opportunity may be found in new green buildings with strong ESG credentials, amenities and accessibility, but there is also a significant opportunity to fund the transition by improving the environmental performance of existing buildings, rather than just knocking down and developing new ESG buildings.

When financing or refinancing new or existing commercial and residential buildings lenders would need to ascertain certain criteria are met. We believe EPC and green building certification are the most readily available and consistent metrics for measuring environmental performance. These can be assessed from day one and over the term of the investment to show measurable improvement while also holding borrowers accountable.

Although lenders may consider excluding inefficient real estate assets as defined by the Sustainable Finance Disclosure Regulation – such as those with an EPC of C or below if built before 2021 – where proceeds of the loan are used to improve energy efficiency and the asset is expected to meet the relevant criteria upon completion of the renovations funded by the loan, then these assets will no longer be deemed inefficient. Once the relevant works are complete, they may even qualify as "green buildings" should they meet specific eligibility criteria.

When funding existing buildings that do not meet energy requirements, lenders can hold borrowers accountable by ensuring loan documentation includes specific clauses on energy performance obligations. This will typically require the borrower to improve overall energy efficiency and/or aggregate green building certification as well as meet specific thresholds such as EPC B or above, LEED Gold or above or BREEAM "excellent or above".

Working together

It is important for the industry to work together with key stakeholders in order to decarbonise the built environment. In our view, EPCs and green building certificates are an important step to improving the transparency of ESG data being shared with the investment community. Using this data, we believe it is possible to improve the energy performance of real estate through a combination of green and sustainability-linked loans (as defined by a third party consultant), occupier and tenant exclusions and key sustainability indicators, designed to measure improvement in a building's green credentials.

As the case for decarbonisation in real estate grows, ESG-focused assets are becoming increasingly desirable. For lenders, this is a potential opportunity to improve environmental credentials whilst also enhancing investment performance.

1) IEA, "Buildings – Tracking report", (iea.org), September 2022.
2) European Commission, "Energy performance of buildings directive", (energy.ec.europa.eu), December 2021.
3) European Parliament, "Energy performance of buildings: climate neutrality by 2050", (europarl.europa.eu), 9 February 2023.
4) UK Government, "Rigorous new targets for green building revolution", (gov.uk), 19 January 2021.
5) UK Government, "Energy Performance of Buildings Certificates Statistical Release: January to March 2023 England and Wales", (gov.uk), 27 April 2023.
6) Gerald Eve, "Energy Performance in Non-Domestic Buildings", (geraldeve.com), July 2021.

M&G Investments

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast.

UK EQUITIES: REJECTION TO RESURRECTION?

London-listed companies are unloved but attractive, so are institutional investors ready to jump back in? *Moira O'Neill* reports.

Like most equity markets, the UK has its ups and downs. This year started well as funds flowed into UK assets, but bank failures in the US and Europe put an end to that.

This is just one of many headwinds UK equities have faced in recent years, with the list including everything from Brexit, frequent changes of government, Covid, war in Ukraine and the spike in inflation. But they have also enjoyed periods of phenomenal returns.

Putting the UK equities picture in a longer historical perspective, Will Ballard, head of equities at Border to Coast Pensions Partnership, says: "They annualised mid-teen returns throughout the 1980s as labour market reforms were enacted and inflation was brought under control.

"Then, following the bursting of the dotcom bubble, returns from 2003 through to 2007 were also exceptional, similarly after the correction induced by the financial crisis in 2008 and then in 2020 with Covid," he adds.

Going global

Today, many analysts believe the opportunity for attractive future returns from UK equities may be at its greatest. UK stocks remain cheap on absolute and global comparisons. As the UK growth outlook improves, and interest rates peak – the UK is very much the laggard internationally in tackling inflation – the prospects for equity inflows must amplify.

Troy Income and Growth Trust senior fund manager Blake Hutchins says: "We're definitely optimistic. One of the big attractions is that the UK is the most international stock market in the world, with 80% of its revenues coming from overseas. But there is undoubtedly a discount for UK stocks."

So why are investors overlooking the region's long-term attractiveness? Equity outflows have dominated the pensions world for many years and this includes UK equities. Stuart Widdowson, portfolio manager of Odyssean Investment Trust, says: "The long-term statistics show that pension funds have dumped UK equities over the past 35 years."

He reports allocations falling from more than 50% of pension scheme assets to less than 10%.

Schroders UK equity portfolio manager Graham Ashby says: "This would have been unfathomable to many of the post-war generation, when there was a boom in final salary pension schemes and a recognition that equities typically provide better long-term real returns than other asset classes, such as gilts or cash."

“

There is undoubtedly a discount for UK stocks.

Blake Hutchins, Troy Asset Management

He blames a succession of raids on the tax advantages previously enjoyed by pension funds (by chancellors Nigel Lawson and Gordon Brown) along with new accounting rules, which put pension assets and liabilities onto corporate balance sheets. This resulted in the closure of many of these pension schemes and a consequent major shift in asset allocation towards bonds.
Typically, XPS Pensions' defined benefit (DB) clients only have a 10% allocation to global equities. Alasdair Gill, a partner at the pension consulting and administration business, says: “There's very little new money on the defined benefit side – so they are de-risking and allocating more to bonds.”
By contrast, in the defined contribution (DC) world, XPS Pensions still sees plenty of assets going into equities and growth assets. However, there is a low allocation to the UK. “It's partly because the UK became a smaller part of the world index,” Gill says.
Also, the growth phase of a DC pot is typically done on a market capitalisation approach and passively, as the mandates tend to go to lower cost investment approaches.
Although the UK made up 10% of global indices about 20 years ago, it's only 4% now. “The fall has been driven by a mix of de-equitisation, fewer initial public offerings [IPOs] to replace companies being taken over – and there is less choice,” Widdowson says.
This begs the question: do international investors need UK exposure? Many now invest in equities on a global or thematic basis rather than in a single country. Ashby says: “Combined with the negative investor sentiment post-Brexit and it's not hard to see why UK equities are so unloved.”

The 1.8% club

But there are other reasons for such a low allocation to UK equities. One is that pension schemes focus on being diversified across sectors and the UK equity market doesn't help here.
Elaine Torry, partner and co-head of trustee DB investment at Hymans Robertson, says: “Diversification is a key risk management tool for pension schemes and that is reflected in the way that the vast majority of pension schemes invest in equities, both at sector and geographical levels.”
Peek under the bonnet of the UK's main stock market indexes and they are dominated by energy and commodities producers (Shell, BP and Rio Tinto), defensive consumer staples (Unilever, Diageo and British American Tobacco), banks (HSBC) and pharmaceuticals (AstraZeneca and GSK), with few of the fashionable technology stocks. And these sector skews are an argument for having more diversified exposure.
UK pension funds collectively now own just 1.8% of the domestic equity market, according to the latest data from the Office for National Statistics.
But it's not just pension funds that are shunning UK equities. The market has undergone a significant change in ownership in recent years. Individual ownership of UK-listed shares fell to just 12% in 2020 (the latest figures available) compared with 20% in 1991. This has broadly been offset by a big increase by overseas institutions.

Deep discount

Today, the significant valuation discount in UK equities is increasingly attracting interest from those overseas institutions. Ashby says: “To be clear, the FTSE100 is not expensive – trading on a prospective price-to-earnings (P/E) ratio of below 11 times. However, this is now almost exactly the same prospective P/E for the FTSE250, even though mid-cap stocks should over time offer higher growth potential. Small caps look even cheaper, with the FTSE Small Cap on a prospective P/E of just over eight.”
This is all in stark contrast to the US, where the S&P500 trades on 18 times earnings. However, Ballard says: “There are big structural differences between the two equity markets that cannot be ignored. Despite that, it is remarkable that this 40% discount is near the cheapest it has been.”
Another sweetener for investors is that the FTSE All-Share offers an aggregate prospective dividend yield of 4.9%. And Schroders says the prospects for dividend growth look good because the dividend cover ratio, which represents how many times a company can pay dividends to its shareholders using net income, is higher than average across the UK equity market.

Unloved, but attractive

Sterling has also been the best performing currency within the G10 so far in 2023, which suggests that international investors are less concerned about the longer-term outlook, even with the uncertainty of an upcoming general election.
Another positive is that the tightening of interest rates is nearing an end. And though inflation may not be completely tamed and the rise in the oil price is problematic, it is still marching in the right direction.

"We believe that UK equities currently offer some of the highest potential for total returns over the next decade," Ashby says. But pension funds are still treading cautiously, as Ballard explains: "For exceptional returns there is a need for exceptional market events. These occur around unpredicted tail events, events which we, as long-term investors and with a responsibility for ultimately looking after the assets of our pensioners and future pensioners, hope are not going to occur in the near future. We would however argue that the UK has the potential to deliver attractive equity returns, in absolute and relative terms.

"It is an unloved, under-appreciated market where headwinds are abating and yet expectations and prices are still low."

But he points out the broad market consensus expectations are only for 2% to 3% earnings growth next year. This stands in stark contrast to global equities, for example, the MSCI World, where expectations are for earnings to grow at closer to 10%. This is despite the FTSE100 generating near 80% of its revenue overseas and having grown its earnings by roughly 9% per annum during the past 20 years.

Pension consultants remain cautious too. Gill at XPS Pensions says: "The UK has lagged global [equity] markets materially for five to 10 years and has caught up a bit over the past three years. But it wouldn't be a reason to take a punt."

Elaine Torry at Hymans Robertson doesn't expect a material reversal in the trend for schemes to diversify geographically. "Whilst the attractiveness of the UK market has arguably improved over the last 12 months, it remains a concentrated market by sector and issuer [with the latter being heavily influenced by global parents] and so is something that would require careful consideration if a meaningful increase was to be made to a scheme's UK equity allocation.

"Ultimately, like all other asset classes, the allocation to any specific region for any asset class, including equities, must be considered in the context of each individual scheme's wider investment asset allocation and needs. There is no 'one-size fits all'," she adds.

To be clear, the FTSE100 is not expensive.

Graham Ashby, Schroders

POSSIBLE PENSION BOOST TO AIM STOCKS

In July, Jeremy Hunt, the Chancellor of the Exchequer, delivered his first Mansion House speech, announcing measures designed to unlock pension investment in unlisted or private companies. The intention is to incentivise companies to start-up and then grow in the UK. Outlined in the reforms was an agreement by nine domestic pension providers to assign 5% of their default funds to "unlisted equities" by 2030.

But investors are still waiting to see whether the agreed allocation includes not just private equity, but stocks listed on London's Alternative Investment Market (AIM), which are quoted, but technically unlisted as it was created to help smaller companies to access capital.

"Having traded on a significant premium for many years, AIM-listed shares are beginning to look interesting," Schroders' Graham Ashby says, adding that the FTSE AIM All-Share trades on a prospective price-to-earnings ratio of 8.5, making it look good value.

Some professionals say boosting UK pension fund's exposure to earlier stage, high-growth companies is uncertain to have an immediate impact on the main market of the London Stock Exchange or bring positive drivers for AIM.

Nevertheless, Odyssean Investment Trust's Stuart Widdowson says: "If AIM stocks are included, I expect they will re-rate materially on the back of new buying. Liquidity is limited and there is a shortage of good quality decent sized AIM stocks."

He also says if this happens, it is likely to be a catalyst for more new companies to list in London.

But nothing is certain with AIM. "Individual share ownership of AIM-listed stocks of 24% is double that of the FTSE All-Share due to inheritance tax advantages," Ashby says.

Business property relief is an extremely valuable relief for individuals who invest in qualifying AIM companies because it can provide exemption from inheritance tax. But this tax advantage may disappear if the Labour Party comes into power, or if Rishi Sunak follows up on his rumoured plans to abolish inheritance tax.

THE FINAL COUNTDOWN

$15bn

The estimated outflow from Chinese equities during August, a monthly record.

Source: The Institute of International Finance

$10trn

The growth of the global debt pile in the first half of 2023 to a record $307trn.

Source: The Institute of International Finance

26%

The level of investors planning to increase their allocation to private assets in the coming year as economic confidence improves.

Source: Preqin

58%

The level of investors wanting to buy properties which do not meet environmental standards to benefit from upgrading them.

Source: Knight Frank

69%

…of institutional investors in the UK, US, Australia, France, Singapore and Japan intend to increase their nature-based investments.

Source: Pollination

83%

The percentage of property professionals planning to give more consideration to ESG when making investment decisions.

Source: Drooms

41%

The level of investors who say that liquidity is a barrier to the Mansion House reforms. 27% cited risk as a factor.

Source: Aon

88%

The percentage of companies globally which increased or maintained their dividends in the three months to July.

Source: Janus Henderson

The global dividends paid in the second quarter, a headline rise of 4.9%, year-on-year, with banks contributing half of the growth.

Source: Janus Henderson

$568.1bn

Quote of the Month

"There's a lot of headlines out there and a lot of them are not so friendly to the investment management community in general."

Damien Pantling, The Royal County of Berkshire Pension Fund

KEEP UP TO DATE
UPDATE YOUR DETAILS NOW

To comply with GDPR and keep receiving insights on the latest trends and issues on institutional investment, ensure you keep your details up to date.

Choose between receiving portfolio institutional magazine in print or digital and subscribe to our newsletter.

pi


LGIM
Inaction is NOT an OPTION
LGIM is committed to creating a better future through responsible investing
LGIM
Find out how:
lgim.com/responsible-investing
Proud partner of Lewis Pugh, UN Patron of the Oceans
For investment professionals only. Capital at risk.
Issued by Legal & General Investment Management Limited. Registered in England and Wales No. 02091894.
Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority.