PORTFOLIO INSTITUTIONAL NOVEMBER 2023

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NARRATIVES:

FEAR AND GREED

AFFORDABLE HOUSING
Capital build

EMERGING MARKETS
Green or gold?

DIVERSITY
Never-ending story

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NARRATIVES: FEAR AND GREED

Monday 19 October 1987 started the same as any other Monday. However, when the day ended it would be forever known as Black Monday.

Unexpected stock market selloffs around the world saw investors share losses of around $1.7trn (£1.4trn). But what caused such a shock?

Were too many investors concerned that stocks were overvalued? Perhaps the new electronic system automatically kept selling as markets fell? Was it because of a weakening dollar? Rising interest rates?

Although analysts could examine various metrics in the days leading up to Black Monday, people want the story of what happened, not data.

A set of solid fundamentals may not be enough to predict the direction of a market, but narratives, such as wars, inflation or elections, could have more influence because people like stories. It helps them to better understand what is happening compared to looking at lines on a chart. Whether it's the truth or not, it's what people cling to.

This month's cover story looks at the current market narratives and how investors could use them to gain an advantage. Our coverage starts from page 18.

One strong narrative is that the queue for cheaper housing is growing, while the number of affordable properties opening their doors for the first time is falling. Is providing cheaper housing a new institutional property asset class or is it just for those looking to generate a positive social outcome? We provide an answer from page 56.

Elsewhere, emerging markets could offer levels of growth the developed world can only dream of. However, with high levels of pollution and inequality, as well as concerns over transparency, the asset class is a responsible investing challenge. From page 40, we look at how investors are navigating the environmental, social and governance risks within emerging economies.

The benefits of building investment teams that hold different philosophies and life experiences have been well publicised, but from page 62 we hear why the journey to creating an investment culture that harnesses difference may never end.

We also review our second annual ESG Club Conference. Find out what happened in the first part of our coverage from page 46 where we focus on the transition investing and biodiversity discussions.

Finally, we sit down with the director of pensions at the Merseyside Pension Fund, who explains his realistic approach to net zero, while the Pension Protection Fund's head of ESG and sustainability discusses the importance of the social factors and the option of last resort.

We hope you enjoy this edition.

Mark Dunne
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PENSION FUNDS PUT GOVERNMENT'S GROWTH PLANS UNDER THE MICROSCOPE

A big gap exists between how pension funds view the government's growth agenda and what the agenda expects of them, finds *Andrew Holt*.

A group of leading pension funds put the government's growth agenda under the microscope at October's PLSA annual conference in Manchester. This comes after the chancellor's rallying call wants to boost economic growth though investing pension capital.

The panel of top chiefs from major British pension funds revealed a certain amount of scepticism for the growth idea.

Neil Mason, chair of the PLSA's local authority committee and assistant director of Surrey Pension Fund, had more questions than answers about the growth agenda.

"What do we actually mean by British growth?" he said. "Are we talking about growth equity, growth debt? Are we talking about growth infrastructure and then, what are we going to call it? Are we going to call it place based? Or local investments? UK opportunities? Levelling up? Or impact?"

The implication being on definition: how are investors going to assess the growth investment opportunities and what do they bring to any investment portfolio. Mason noted that when it came to growth, there are in fact many in the local government pension scheme (LGPS) who have been investing in this area for some time. "The Great Manchester Pension Fund, GLIL, the Local Pensions Partnership, the Brunel pool, Border to Coast and South Yorkshire Pension Fund. So we have a serious track record in this," he said.

Mason then added there is a central principle all LGPS funds need to consider within the growth agenda debate. "From our perspective at the LGPS it is to generate the cashflows that we need to match our liabilities moving forward."

And under such a criteria, "we are looking at six areas where we feel we can generate growth for the British economy," Mason said. These six are: housing, property, infrastructure, corporate financing, social bonds and renewables. "We feel we can meet local objectives – depending on what you define as local objectives – but we can also meet the erstwhile net-zero plans of UK plc," Mason added.

His central message being there may well be a fit for pension funds to investment in growth, albeit however vague this may be defined, but it must be suitable for the fund as a starting point.

Not the job of pensions

Elizabeth Fernando, Nest's chief investment officer, was even more categorical on this point, as she noted applying a government agenda isn't what pension funds are about. "We are not against a levelling up agenda. But that is not our job. Our job is to build those returns for members. And we don't want the permanent impairment of capital, because that is the ultimate risk for a DC member. Losing permanently a proportion of their capital is disastrous. That is why we don't go into the early venture stage. We want proven business models and then we give capital to help scale," she said.

Nest has a 5% target for private equity, as part of being signatories to Jeremy Hunt's Mansion House Compact, and 30% for illiquid assets.

But like Mason, Fernando highlighted how this wasn't new for Nest. "We have already been investing in private equity – our private equity programme started just over a year ago – and we were doing private credit and infrastructure before that, so we have already built up a reasonable exposure in private assets."

She said overall about 19% of Nest's portfolio is in unquoted investments, with the likelihood that this number will rise.

Real need

Taking the arguments about growth further, Morten Nilsson, CEO of the BT Pension Scheme (BTPS), identified the wider scope of the growth investment argument. "The first thing for me is that British growth requires a lot more than venture and equity investments. There is a real need for infrastructure investments, there is a real need for the energy transition and all sorts of other things," he said.

Nilsson commented on the nature of the BTPS within the context of the debate. "From our perspective we are a mature pension scheme. The average age of our members is 68. We are on a de-risking path where we need to make sure the funding is as stable as we can get it.

"We are looking for, like other closed DB schemes, secure income and cash-flow generating assets, where we can depend on that cashflow. There is a real need for that in the UK also."

But Nilsson noted it will take work from the government to move the issue forward. "The government has a real opportunity to help facilitate people like us who have a slightly less risk appetite than a lot of the headlines have been talking about. But actually have quite a lot of money and want to deploy it in the UK and seek those assets," he said.

Reinforcing the message that pension funds already invest in this area, he added that BTPS is, contrary to belief, already committed to UK assets. "In all this debate it all sounds like we are not investing in the UK. If you look at BTPS, 64% of investments are UK related," Nilsson said.

As a final warning, David Hourican, chief financial officer at The British Business Bank, which could well prove an important facilitator in the whole business, said: "There are some structural impediments in investing in venture and growth assets."

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INSTITUTIONAL INVESTORS TURN TO FIXED INCOME AS UNCERTAINTY BITES

Asset owners are looking to boost their bond allocations thanks to an unpredictable macro-economic outlook – a massive turnaround from a year ago. *Andrew Holt* reports.

Asset owners are fixated with fixed income again due to growing pessimism over the prospects of the global economy and risk assets in the coming year, according to a survey.

The study of UK, European and Asian asset owners also found that they foresee much uncertainty amid unresolved economic issues, with diverging expectations for growth, inflation and monetary policy.

Despite ongoing uncertainty, improved fixed income fundamentals have sparked renewed interest in the asset class, with asset owners and other investors expected to boost bond allocations – 58% indicated an intention to increase allocations versus 7% who expect to reduce their exposure.

Within that interest in fixed income, half of respondents are set to boost positions in green bonds and investment-grade credit over the next year, followed by sovereign debt at 43% of respondents, according to the survey from PGIM Investments.

The primary regional difference between asset owners was within emerging market debt, with 51% of Asian asset owners set to increase exposure to the asset class, compared to just 36% for their European peers.

Fixed fashion

Pension funds see much that is positive with bonds, as the fixed income outlook chimes with Border to Coast's fixed income portfolio manager Daniel Loughney. "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," he said.

The pensions pool believes that as a long-term investor, bonds, including those that are inflation linked, provide 'a two birds with one stone' opportunity. "Generating attractive income and also helping to match a portion of liabilities," Loughney said.

He noted that medium-dated gilts now yield 4.5%. With inflation metrics slowing and bond volatility falling, gilts are appealing, with index-linked bonds – where coupons are linked to inflation – looking 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.

Similarly, while investors have been challenged by the increasingly correlated performance of bonds and equities, more than two-thirds of asset owners believe fixed income will reclaim its long-held role as a portfolio diversifier to stock volatility.

While interest rates have spent more than a decade at ultra-low levels, expectations are that developed market rates are set for a sustained period hovering within the range of 3% to 5%.

Search for yield

Should this materialise, investment-grade returns should be in the mid-single digits for the foreseeable future, with high-single-digit returns for higher-risk sectors.

Matt Shafer, head of international distribution at PGIM Investments, said: "With the majority of rate hikes now in the rear-view mirror, we could also see reduced fixed income volatility and a reemergence of the search for yield – which can provide an additional performance boost for bond strategies."

Newton Investment Management's head of mixed assets, Paul Flood, shares his enthusiasm for bonds. "We now see bonds offering higher yields and providing better diversification as part of a multi-asset portfolio. We've even gone so far as to herald the 'rebirth' of the 60/40 portfolio," he said.

In this environment, Flood said there is real potential to make decent returns in the bond market. "We have reduced the exposure to alternatives, choosing to reallocate resources up the capital structure in the bond market, given bonds' attractiveness as an income-producing investment," he said.

So bonds are buyable again based on their potential to generate returns and for diversification. "In our view, bonds should once again play a role in a well-diversified portfolio, one that also keeps exposure to growth opportunities within equity markets, and to real assets that can provide an attractive level of yield in the inflationary environment," Flood added.

Top of the list

But where should investors look within fixed income? Having studied the trends in the bond market, Nigel Jenkins, managing director at asset management boutique Payden & Rygel, believes that he has the answers, citing the US as being close to the top of the list for investors looking at bonds, particularly treasuries, with TIPs, or inflation-linked treasuries.

Investors can get a 1.9% yield on a 10-year inflation protected security backed by the US treasury, Jenkins said. With inflation risk down, there's still more of it than there has been at any other time in the last 20 years, he added.

The argument Jenkins presents is that if investors can get close to a 2% guaranteed yield in excess of whatever inflation turns out to be, with the backing of the US treasury over 10 years, that is a decent real yield. "That's a higher real yield than you can get in most other markets as well," Jenkins said.

The move to bonds has occurred at a rapid rate. It comes after 2022 saw one of worst bond market selloffs in a generation after central banks aggressively raised interest rates to contain inflation.

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PEOPLE MOVES

The Pension Protection Fund (PPF) is looking for a new chief executive after **Oliver Morley** quit to takeover The Money and Pensions Service.

He will leave the fund that manages £32.5bn of assets for distressed defined benefit schemes in December.

Morley (*pictured*) joined the PPF five years ago to lead the organisation's digital transformation. His replacement will have to shape the fund's next strategic plan.

Local Pensions Partnership Investments has appointed **Louise Jack** as its new chief operating officer. She will also sit on the executive committee.

Jack brings more than 20 years of financial services experience to the pool, where her duties will include being responsible for the investment operations and business change teams.

Professional trustee specialist **Vidett** has announced that **Adrain Spann** and **Kerry McDermott** have become trustee directors.

They were just two of 13 promotions that became effective at the start of October. The other promotions have seen people move up to associate directors and head of compliance.

Pensions for Purpose, an organisation that helps pension funds make positive impacts with their capital, has welcomed **Richard Giles** as a senior director.

Giles is the investment committee chair of United Utilities' retirement scheme.

He is also vice trustee chair of the Scottish Teachers Pension Scheme and was a director of TPT Retirement.

He also enjoyed an 11-year stint at PwC, where he was a partner and head of pension advisory in the North and spent more than 17 years at Mercer.

CALENDAR

Topics for confirmed upcoming *portfolio institutional* events:

November

– Sustainable strategies roundtable

December

– Real estate roundtable

25 April 2024

– Private markets conference

NOTICEBOARD

Brunel Pensions Partnership has chosen **Neuberger Berman** to manage its third-cycle private equity portfolio. NB Clifton Private Equity III has £626m to invest, 40% of which will be allocated to making a positive impact on people and the planet. The remaining capital will be invested responsibly.

Meanwhile, six pension schemes within the Brunel pool have collectively invested £330m in renewables specialist **Schroders Greencoat**.

The capital will be invested in energy transition assets such as wind, solar, green hydrogen and batteries across the Southwest of England.

Schroders Greencoat manages assets that collectively generate 2.8GW of energy, removing the need to emit more than 2.6 million tonnes of carbon.

Nest is searching for fund managers to help its 12 million members gain exposure to sustainable forestry. This would diversify the master trust's portfolio due to its low correlation to mainstream stocks and could hedge inflation.

Katharina Lindmeier, Nest's senior responsible investment manager, told *portfolio institutional* that the footprint of this strategy could potentially reach South American countries like Chile.

Imerys UK Pension Fund Trustees has appointed Aon as its fiduciary manager.

The £550m pension fund is sponsored by Imerys Minerals, which processes industrial minerals.

Aon has provided investment advice to the scheme for more than a decade. This new relationship will give the scheme more investment options and allow it respond faster to market changes.

A £25m social impact fund backed by **Big Issue Invest** has backed two companies.

It invested £250,000 in Lightning Reach, which supports people suffering from financial hardship. It also allocted almost £260,000 in chocolate company Harry Specters, which employs and trains young people with autism.

The fund, which is also backed by Bank of America and the Joseph Rowntree Foundation, has so far invested £1m.

In a sign that improved defined benefit funding levels due to higher interest rates is leading to more demand for de-risking, the pension scheme sponsored by the **London Stock Exchange** has completed a £335m bulk annuity deal with **Standard Life**.

The deal, which was completed in May but was not announced until October, covers the longevity risk of 1,740 members of the exchange's scheme.

The Northern Bank Pension Scheme has also completed a bulk annuity deal. **Prudential Assurance**, part of M&G, has secured the benefits of almost 2,000 current and former employees of the Northern Irish bank following the £286m deal.

The membership is now fully insured earlier than expected in a journey that started with a buy-in between the two parties back in 2015.

Prudential Assurance also has de-risked one of the schemes within its own group through a £331m full scheme buy-in.

The deal secures the benefits of **M&G Group Pension Scheme**'s almost 1,500 pensioner and deferred members, while active members were given the choice of joining a different defined benefit scheme or transfer to defined contribution fund.

THE BIG PICTURE: INVESTORS TARGET HEDGE FUNDS

Pick your hedge: Where investors are investing ($bn)

	Aug	YTD 2023	2022	2021	Est. AUM
All Hedge Funds	($6,10)	($50,07)	($112,19)	$13,92	$3.468,15
Fixed Income/Credit	$1,12	($3,65)	($48,36)	($36,34)	$956,53
Commodities	($0,81)	($2,27)	($4,07)	$10,31	$119,55
Multi-Asset	($2,90)	($5,96)	($29,12)	$31,33	$1.289,29
Equity	($3,51)	($38,14)	($27,40)	$8,57	$1.162,08
Primary Strategy	**Aug**	**YTD 2023**	**2022**	**2021**	**Est. AUM**
Market Neutral Equity	$0,76	($0,52)	$0,02	$2,78	$86,81
Directional Credit	$0,68	($1,19)	($26,57)	($11,97)	$141,69
Relative Value Credit	$0,46	$1,73	($5,52)	$0,84	$239,07
Convertible Arbitrage	$0,11	$0,44	($0,26)	$2,53	$69,07
Multi-Strategy	($0,18)	$2,39	$6,21	$23,17	$680,01
Managed Futures	($0,58)	$4,36	$6,12	$12,98	$197,63
Long/Short Equity	($1,19)	($20,00)	($38,02)	($16,48)	$707,69
Distressed	($1,19)	($3,74)	($4,71)	($2,24)	$228,06
Macro	($1,24)	($3,71)	($31,40)	($5,07)	$233,21
Event Driven	($2,10)	($20,82)	($7,55)	$3,73	$571,99

Hedge funds continue to appeal to investors even if the strategy shifts, finds *Andrew Holt*.

Hedge funds continue to prove attractive to investors with some notable net inflows within most hedge fund strategies, according to eVestment.

The most notable theme was a resurgence of interest in fixed income/credit strategies seeing a second consecutive month of net inflows.

This looks to be a reaction to the evolving global rate environment bringing with it a perception of a broader opportunity set for these asset classes.

The group has endured a long stretch where the market for capital raising has been difficult, and so it is intriguing to see investor interest return.

Hedge funds operating credit-related strategies have endured a long and rocky stretch for attracting new assets.

Part of the issue has been a rise of interest in private credit strategies where liquidity terms may have been better aligned with the most attractive opportunities, but the evolving global rate environment is making opportunities for fixed income/credit hedge funds more attractive.

Since May, this segment of the industry has seen $2.3bn (£1.9bn) of net inflows alone.

Net inflows at the product-level have gone to a diverse set of strategies from event-driven products, which generates value by taking advantage of stock mispricing that results from events, to insurance-linked strategies, where performance this year has been among the best in the industry.

Investors look set to be more than willing to maintain exposure to these strategies heading into 2024.

In fact, many market analysts have suggested three styles could well prove appealing to investors going forward. These are the aforementioned insurance linked strategies, thanks to yields remaining high following a continuation of tighter reinsurance capital and higher money market rates.

Second is equity market neutral. This is based on the fact that single stock correlations are low on a historical basis, suggesting a good environment for equity market-neutral strategies for picking winners and losers.

And third is discretionary global macro. Here managers are understandably following inflation trends, differences in regional data, and the potential impact of central bank and government policy on economic growth, among other key macro indicators.

It is not surprising that investors are turning to hedge funds. Historically, it should be noted that, hedge fund returns have been higher during periods of rising rates.

Janice Turner is a co-chair of the Association of Member Nominated Trustees (AMNT).

CDC IS THE FUTURE. LET'S GET IT RIGHT FROM THE START SO WE DON'T FAIL THOSE WHO NEED IT MOST

Recently I had the privilege of being invited by the House of Commons Work and Pensions Select Committee to give evidence on issues around defined benefit (DB) pension schemes. During the discussion, in which I urged that the regulator should make a greater distinction between open and closed schemes, the issue arose about the future of pensions in general.

This is obviously critical to the prospects of all working people in this country. DB schemes remain the gold standard and AMNT will fight hard for open schemes to remain so, rather than be regulated into their graves. But as only a shrinking minority of people are accruing benefits from these schemes, what must come next?

We should never forget that the whole point of the pensions system is to enable millions of working people to retire and have a decent life. After a lifetime of work that should not be too much to ask for.

The 2004 Pensions Commission quantified this and it has stood the test of time: it said that for people on average wages to have a decent retirement, a pension equivalent to about two-thirds of their pay would be required. DB schemes succeeded in enabling workers to have a decent retirement because of their link to this objective.

A typical worker in a DB scheme accruing at one 60th knew that if they worked for the company for 40 years' they would retire with two-thirds of their final salary. Employers were required to make contributions that would achieve this.

The move to DC changed all that. As there was often no clear objective it enabled the less generous employers – even those who didn't take the opportunity to move to the auto-enrolment minimums – to get away with scheme contributions far below any that might have a sporting chance of reaching such outcomes.

The result is that millions of people in this country will be left without enough to live on in retirement. Obviously, they will be better off than they would have been without an occupational pension, but a pension system that leaves Britain's workforce "a bit less poor" has failed – and those low employer contributions will lead to more people needing pension credit, increasing the cost to the economy.

AMNT has long believed that after DB, collective defined contribution (CDC) pensions have the best chance of delivering the size of pension that workers need. But in order to do this, new multi-employer CDC schemes must begin the right way, which is to work out how much needs to be contributed in order to have a good chance of reaching a pension equivalent to two-thirds of their pay. Obviously these objectives can't be promises – that would turn them back into DB schemes – but the level of contributions that are necessary from employers as well as members to provide scheme members with a decent retirement must be absolutely kept front and centre. This clarity of focus is required if we are not to repeat the mistakes of the past.

Doing this would heal the generational divide in which the new entrants to the labour market have little to look forward to. But even if we achieve this – and we clearly could – there is still an 'elephant in the room': the growing battalions of casual, freelance and self-employed workers with no access to occupational pension schemes.

According to the Office for National Statistics there were 32.9 million in employment over the summer but only 28.5 million of these were employees. More than 4.2 million were self-employed. The long-term catastrophe for these workers can be found in industries where freelancers have had to keep working for as long as they could to find people to hire them as they had no pension other than that provided by the state. Many of these workers have not chosen their self-employed status – it has been thrust upon them by employers wanting to cut costs by avoiding, for example, the necessity of national insurance and indeed pension contributions. So, in drawing up the new CDC model, I urge the architects to ensure it includes ways for the casual, self-employed and freelance workforce to be included in this new system and benefit from the efficient structure and improved outcomes it provides.

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MAKING THE MOST OF MASTER TRUSTS

The rapid growth of DC master trusts has considerably impacted how they operate. Regulation has also played an important role and, with a general election due in 2024, pensions policy may be about to become more politicised.

At the PLSA's Master Trust Forum held on 19 September in London, our members discussed the many issues facing the sector and how they plan to tackle them.

One of the biggest issues facing the pension industry – and generating a lot of discussion at the event – was the development and expansion of collective defined contribution (CDC). In addition, employers and trustees are increasingly taking note of the advantages master trusts offer, including greater regulatory support and investment expertise.

Government support for increasing contributions – such as moves to lower the age of auto-enrolment – could play a key role in increasing the size of the market.

Finally, some master trusts highlighted the key role they can play in demonstrating best practice to the rest of the pension industry, including how they can deliver lower costs and better investment outcomes to help scheme members achieve their retirement goals.

Representatives from The Pensions Regulator and HM Treasury on our Value for Money session discussed how regulation impacts master trusts and how they can demonstrate value to their members.

Although there are examples of how master trusts have delivered great outcomes – the data is often inconsistent and not comparable, and this has made it difficult for master trusts to compete. However, delegates heard how the government is keen to help master trusts and the workplace pension sector demonstrate how they are delivering value for money.

The Value for Money framework may drive further consolidation in the industry, as smaller schemes wishing to join larger trusts can compare them by investment performance and costs.

While the industry is making steady progress in creating good value for money and implementing processes to improve comparability, some schemes need to catch up. This may ultimately lead regulators to enforcement, although engagement would be the first step.

Several master trusts spoke about their actions to improve diversity, equity and inclusion (DE&I) within management to better reflect their membership. Several master trusts explained how they are trying to encourage more people from minority backgrounds into the industry.

While recruiting people from a diverse range of backgrounds can be challenging, master trusts are using practical techniques, such as anonymising CVs. Others are considering applicants without an industry background but with expertise in other areas and industries. However, it remains a challenge to improve DEI within master trusts at the trustee level.

In the final session, master trusts discussed the steps they are taking to help future-proof their default options. The debate featured the Mansion House Compact, a voluntary initiative that allows pension scheme signatories to express their interest in increasing their allocating to unlisted UK equites, which the government hopes will boost the economy. Some master trusts stated they have signed up, but many more are still considering what it would mean for their members.

Much of the discussion focused on how the reforms could impact the risk and diversification of their portfolios. Some schemes were happy to make greater allocations to private equity due to the higher expected returns from the asset class; others preferred to adopt a wait-and-see approach before making any changes.

A key consideration in master trusts' investment decisions is the range of members they serve. Default strategies are becoming increasingly sophisticated to cater to a widening range of risk appetites. And some master trusts reported that their members prefer flexible strategies that allow them to change their minds, rather than committing to specific outcomes.

Some master trusts are embracing ESG in their default strategies, based on the assumption that most members want their pension savings to impact the world. However, depending on how integrated ESG factors are in the investment strategy, this can involve greater sophistication.

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INTERVIEW – PETER WALLACH

“It is not down to the government to determine what pension funds should do.”

The director of pensions at the Merseyside Pension Fund talks to *Andrew Holt* about the search for income, being realistic about net zero, the problem with venture capital and the importance of being humble.

What’s in your investment portfolio and why?
Our portfolio is one you would typically see in a pension fund such as ours. We have 50% in equities, 20% in bonds and 30% in alternatives. We are one of the most mature local government pension schemes (LGPS), in terms of liabilities. It means we have been thinking more about income.
And we have been increasing our allocation to alternatives, particularly income-producing alternatives such as infrastructure. Over the next 12 months, we expect to move more from equities into bonds to generate more income and to dampen risk.

How would you typify your investment philosophy?
I try to keep it simple: it is easier to lose money than to make it. So we try to avoid losses – the preservation of capital is important to us.
We take a long-term perspective and are sensitive to fees. We don’t mind paying fees, where the performance justifies it, but where it does not, we are reluctant to pay up.

What is your approach to ESG and net zero?
They are important to us as captured in our responsible investment policy. We believe ESG factors have a material influence over the long term, and it is important to consider them at the beginning, as well as throughout the investment process.
In terms of net zero, as a LGPS fund, we have a net-zero by 2050 commitment. We are working on managing climate risk and looking at ways in which we can set some milestones to measure and track our progress to net zero.

What will that mean in practice: divestment from some investments, perhaps?
At the moment engagement is what we are doing, and, in my opinion, it is the sensible way to manage ESG and net zero. There may be occasions where divestment needs to be considered. We

are looking at putting some form of framework in place, which will enable structure and decision making on that.

Are the ambitions towards net zero by 2050 realistic and achievable?

The short answer is yes. They are achievable by 2050, providing the work with other investors and companies continues. But I do feel that it is very ambitious.

What challenges does that create for you?

A challenge in so far as aligning with Paris [Accord] benchmarks and relying on businesses that have sensible plans, can be justified and achieved.

We are investing globally, and in a world where there are good intentions, but there are other things that sometimes take priority over climate policy, which is understandable.

Therefore, and this is a key point: if there isn't a real commitment from government and industry then there is a case that institutional investors like us can only go so far on the issue. We have to be realistic about that.

So there is a strong element of realism in terms of net zero?

It is not sensible to get too far ahead of the curve. It is absolutely sensible to do things in a more energy efficient way and to implement measures that are cost effective in terms of addressing climate risk.

Spending money on virtue signaling in terms of having a low carbon portfolio, doesn't necessarily stack up from an investment perspective.

Take carbon offsets, we have seen evidence that they are difficult to certify. If they are a mechanism for achieving net zero, then it is an example of how difficult things are going to be.

The government has been keen to push the message about pension funds investing in infrastructure. You have exposure here, so do you agree with the government?

As a pension fund, we have more than

Spending money on virtue signaling in terms of having a low carbon portfolio, doesn't necessarily stack up from an investment perspective.

£900m in infrastructure. We started well before 2015 when the then chancellor started promoting pension fund investment. We continue to invest in infrastructure because we invest in long-term assets with characteristics that fulfil our requirements. But it is up to each pension fund to determine what is right for it. It is not down to the government to determine what pension funds should do.

What do you make of other initiatives like the northern powerhouse and levelling up? Do they amount to much from an investor perspective?

I don't believe they do. They have good intentions. But based on the levelling up criteria, we are invested in projects that already fulfil that. But as with infrastructure, we have done them for investment reasons.

Was the cancellation of the northern leg of HS2 a disappointment?

Personally, it was. It was a short-term decision, but it has no investment implications for us.

What I took away from it was the publicity about the way that costs spiraled versus the equivalent projects in Germany, France and Spain, which are typically much less expensive.

It is a question of why does infrastructure cost so much in this country. We need to get to the bottom of that. There are large projects needing to be undertaken, but at a sensible cost.

What did you make of Jeremy Hunt's so-called Edinburgh Reforms, encouraging pension funds to invest in illiquid assets, such as venture capital?

One has to consider whether venture capital is suitable for pension funds, because it is higher risk and higher cost. So for institutional investors to be interested, venture capital needs to come with some additional incentives.

As we have the whole range of private equity-type investments to choose from, from a fiduciary perspective, why would we choose to invest in UK venture capital over other opportunities?

Your illiquid assets make up 30% of the fund, including private equity, infrastructure, private credit and property. Why those are in your portfolio?

We have been invested in private equity for more than 30 years. We have a well-developed private equity programme that has provided very good returns. Strategically, it has grown to be a larger part of our portfolio than we want it to be, so we will dial it back. Infrastructure and property are held through a number of funds and direct investments. The latter helps us in taking long-term buy-and-hold positions.

You are part of the Northern LGPS pool. How does that relationship work for you?

It works well. It enables us to concentrate on where the biggest savings are for us, like in private markets and private equity – we helped establish the northern private equity pool which has commitments of more than £2.5bn. There is also within the pool the GLIL infrastructure platform, which enables us to invest into direct

infrastructure projects, cost effectively. LGPS pooling helps us to work together to improve scale, resource and manage overall costs.

As a pool, the Northern version is the one that probably gets the least publicity. Is this a good thing?
No, because a number of the initiatives we undertake are overlooked and don't get the recognition they deserve. Equally, we are able to get on and deliver our objectives without being interrupted.

Is there a negative side to pooling?
Initially, I was dubious. But, in aggregate, it has delivered. It, among the other things I have mentioned, has also improved investment governance. But it is not a one-size-fits-all approach. It needs to allow for different approaches by LGPS funds. And I would like to see that flexibility continue.

What do you make of funds having to pool all of their assets by April 2025?
I can see why the government wants to see it completed expediently. But, as some of the pools and funds have said, the deadline is too soon. And, for example, passive management doesn't fit the pooling system. It would add cost without a commensurate benefit.

For institutional investors to be interested, venture capital needs to come with some additional incentives.

Between now and then there may be a change in government, so it may change.
I anticipate that whichever administration is in power there will be a similar approach to the LGPS. There will be a pragmatic solution to recognise that it is not just about achieving full pooling, and so, some form of compromise will be reached.

How do you view the pooling system overall?
The LGPS has always been a great place to channel ideas and for collaboration. I would not want to see that diminished as pooling develops.

You are a member of GLIL's investment committee. What does that involve?
It involves a great deal of reading. GLIL's investment committee is the governance body which oversees the activities of the investment and asset management team. As a minimum, we have monthly meetings and other meetings when needed. GLIL offers us great insight in terms of activity and pricing of infrastructure assets. Its portfolio gives us good exposure to renewable energy and low carbon transition-type assets in a cost-effective way.

What have been the biggest challenges you have had to deal with as director of the fund?
Although investment crises get the headlines, administration is the heart of the pension fund, and that is often one of the biggest challenges. Administration is far more complex than appreciated, the ever-changing regulatory environment does not help, and importantly, which is often overlooked, the people doing it have a particular knowledge and skill which is difficult to replace.

Do you see the high inflationary environment being a problem going forward?
I do. Our liabilities are indexed to inflation. It means that persistent inflation means higher liabilities. High interest rates are a temporary phenomenon for us, whereas inflation is a permanent challenge because it is baked in.

So how do you see equities in this environment?
They are the lowest cost of the engines of growth for pension assets over time.

What other economic or geopolitical challenges do you foresee?
The main one, given the global situation, is governments servicing their debt costs. Which probably means taxes are going to remain structurally high and that will be a challenge for financial markets, industry and us.

What are your primary aims for the fund?
They are twofold. I mentioned climate risk and ESG in terms of embedding them more into our investment strategy, but alongside that there is a need to increase income from our investments and to improve the inflation linkage of our liabilities.

You have been an asset manager and worked in private banking: what is the biggest lesson you have learned in that time?
Two things: be humble and cut your losses when the need arises.

PETER WALLACH'S CV

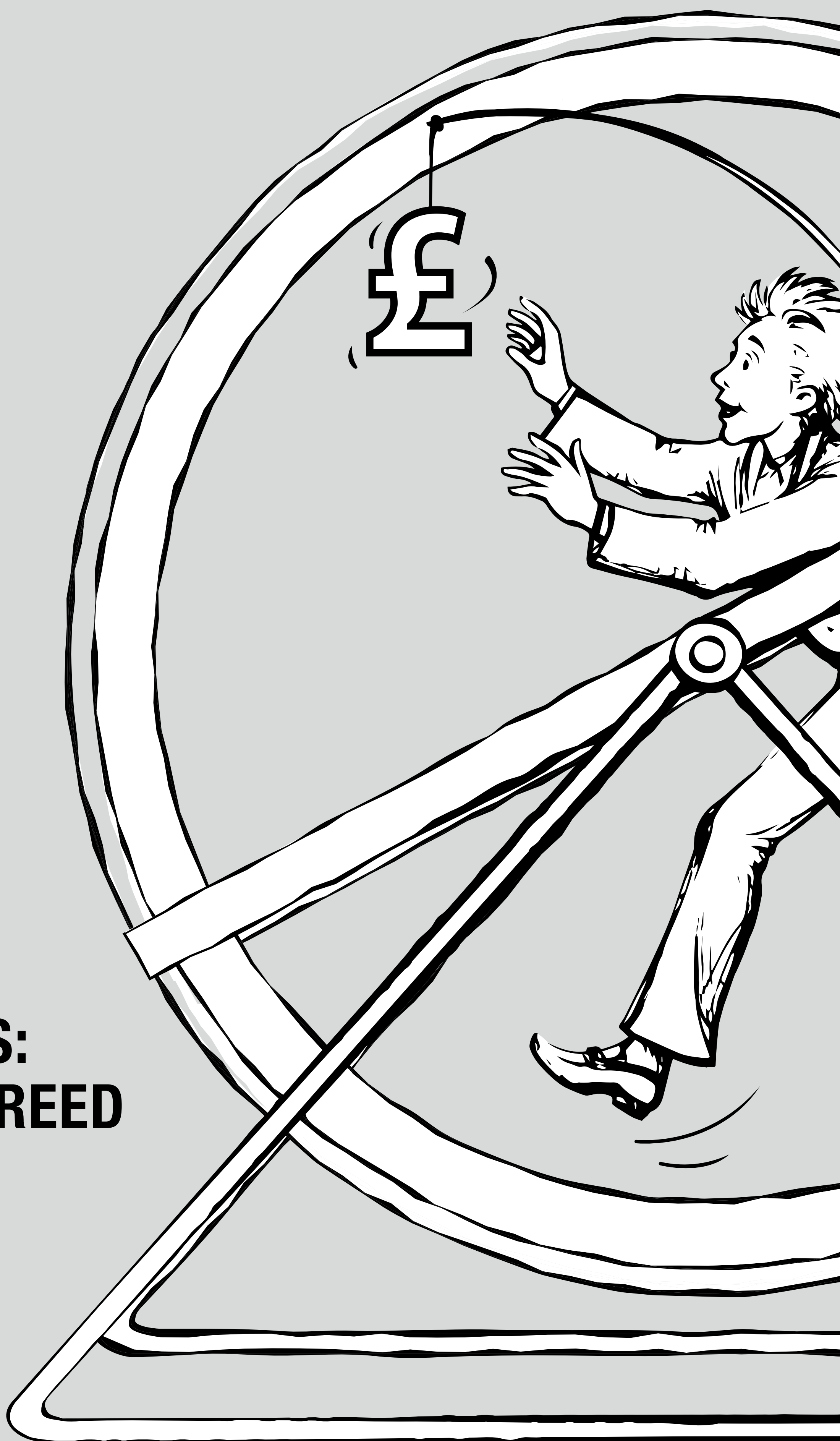
2007 – present
Director of pensions
Merseyside Pension Fund

2004 – 2007
Compliance and strategy manager
Merseyside Pension Fund

1997 – 2004
Investment manager
Close Wealth Management

1985-1997
Private banking and portfolio management
Coutts

Peter holds an MBA from Sheffield Hallam University



NARRATIVES: FEAR AND GREED

Andrew Holt explores the idea of narrative-driven markets and what they mean for investors.

Markets are not rational. If they were, no one would make any money. Strong fundamentals are sometimes not enough to stop the value of an asset falling. The economic and market narratives can be a bigger factor. And every investor wants to predict the future, to spot the influences that are shaping the investment universe. If you can unearth that, you are potentially on to a winner.

This year, that narrative has been a soft landing – one where central banks will succeed in bringing inflation under control. And it is a narrative that the pessimists appear to have got wrong. Although, some believe the jury is still out here.

So what is the latest economic narrative we are living under? What does it tell us about the markets? And more importantly, how should investors react?

One economist who has a formula to find out is Michael Metcalfe, EMEA head of macro strategy at State Street Global Markets. Every two weeks, he examines the intensity of media coverage around certain terms to see whether changes in that coverage show a correlation with market movements.

"If coverage and market impact [correlation] are above the historical average, we note this theme as showing important market hype and plot this on what we call a narrative map, which helps us identify which narratives are important for markets at any given time," Metcalfe says.

So what narratives has he identified that are driving markets today? Metcalfe cites three: international conflict, investor sentiment and interest rates. "International conflict has sadly never been far from the headlines," he says.

Read all about it

How these themes have played out from a narrative perspective is intriguing. "The media intensity and market impact of the narrative first spiked in mid-January 2022, as the press speculated about Russia's coming invasion of Ukraine," Metcalfe says. "It remained a market-driver for the next five months and its influence on markets has continued to ebb and flow."

Then in early October, changes in the narrative were once again impacting markets, but the media coverage had become less intense. "Now with the tragic occurrences in the Middle East, the conflict narrative has risen to its highest level since the immediate aftermath of the outbreak of war in Ukraine. It remains unclear how long this conflict will last."

Indeed, how the Israel-Hamas war plays out could create a whole new narrative trend. Wider geopolitical factors coming into play could create a new world of disorder, and with it, a whole new narrative potentially edging towards a bleak outlook. Paul Flood, head of mixed assets at Newton Investment Management, emphasises the global disparity. "East and West are at different points here," he says. "It's not great for bringing people together."

Fiction is your enjoyment and your non-fiction is facts. You should invest on a non-fiction basis.

Paul Flood, Newton Investment Management

Investor sentiment

On a different level, how the conflict impacts oil prices and the commodity markets and with it inflation, is a considerable narrative. But it should be noted in the immediate aftermath of Hamas' horrific attack on Israel, global markets were unmoved.

When it comes to interest rates and the investor sentiment narrative, Metcalfe finds, within his analysis, above average media coverage and impacting market returns. Both are "intuitive", he says.

Expanding on this, Metcalfe adds: "Bond market volatility has been exceptionally high, so the market narrative on interest rates and what central banks are saying about them have been impactful for market returns.

"Then together with heightened geopolitical risk and interest rate volatility, news on investor sentiment and how they are reacting has also become more important. In particular, whether investors simply fall back to the benchmark are positioned to be significantly more defensive than they already."

How investor sentiment reacts to this narrative and the reality of high rates for longer, as well as heightened political risk, will prove crucial for market outcomes in the final quarter of this year and beyond.

The reaction of investors is not the only central factor in the narrative outlook. "Arguably how central banks react to this combination of risks will be even more important," Metcalfe says. "We note that coverage of central banks everywhere has become less hawkish."

So with conflict, sentiment and rates being the dominant media narratives driving markets, investors have responded, Metcalfe says, by adopting a more defensive and less cyclical posture across their portfolios as well rebuilding overweight positions in safe havens such as the US dollar.

The Fed fails

Michael Field, senior equity strategist at Morningstar, says that one of the narratives that has been spun, admittedly successfully, since the financial crisis has been the idea that central bankers have such a hold on monetary policy that they can steer the economy clear of recessions through the tweaking of interest rates.

"It is this belief that is central to the idea of a soft-landing. But it is far too early to say the pessimists have gotten it wrong," he says, turning the current accepted narrative on its head.

A key narrative is that European markets are fairly valued, according to Morningstar. "They are not cheap, but we cannot say they are expensive either," Field says.

However, what they are not doing is pricing in a recession. "The market still very much has this belief, that we will be able to avoid a recession," Field adds.

Central to this belief is the idea that interest rates have peaked, and that inflation will fall away from here, allowing central bankers to cut, and for the economy to continue to grow at a moderate pace.

This, Field observes, is the narrative that investors are still largely buying into. "But it contains one major flaw – the assumption that inflation will continue to fall rapidly from here," he says. "While, inflation has basically halved from the double-digit highs witnessed late last year, explained largely by falling food and energy prices, this is only the first part of the fall and was the easy part."

A sticky problem

This does, therefore, have an important inflation narrative – but not in the way we currently understand it. As what this means is we are now left with goods and services inflation, which is much stickier, and could take years, not months, to fall to anywhere near central banks' 2% target.

This new narrative around the problem of sticky inflation could be with us for some time, presenting obvious challenges to investors.

"So, the assumption that central banks, like the conductor of a symphony orchestra, can perfectly harmonise rates to fall just enough to avoid recession, while still being high enough to quell inflation, is somewhat fanciful," Field says.

For him, the more likely scenario now, and something central bankers are intimating, is that we may have to live with higher rates for longer. What, therefore, does this mean for growth-focused equities?

"It means their valuations will likely have to correct again," Field says, "while corporates with high levels of debt, and hence high interest payments, may see the value of their bonds adjust to the higher level of risk attached to operating in a higher interest-rate environment."

Blowing bubbles

Looking at things differently, David Jane, a fund manager in Premier Miton's macro thematic multi-asset team, offers something of a contrarian analysis on the narrative-driven markets idea. "In my view, the effect is actually reversed. Narrative follows price.

"The broad majority of investors leap onto a narrative to explain price movements," he adds. "Human nature needs stories to explain things, not data."

A good example he cites is the apocryphal story of the fund manager asking his broker why a stock has risen strongly. In the absence of a good answer the broker says: 'more buyers than sellers'. "A classic case of narrative following price," he says.

Expanding on his thinking, Jane says that once a narrative becomes established a so-called 'reflexivity effect' takes hold. "Price movements reinforce the narrative, proving the narrative true and so on," he adds. "This is especially true where liquidity is abundant. This process can ultimately lead to bubbles forming," he adds.

Adding to his interpretation, Jane expands further. "Narratives are basically shorthand for explaining what are highly complex systems," he says. "This leads to obvious inconsistencies of rising bond yields, on the higher for longer argument, but growth stocks, such as the magnificent seven, performing strongly on, supposedly, the artificial intelligence (AI) story. It is difficult to put a consistent story across both."

In Jane's view, the overriding, long-term narrative, will likely remain 'higher for longer', the end, ultimately of the disinflation narrative. "This will set the overall market regime for the coming years, but will no doubt be interspersed with other stories, such as reshoring, AI, energy and resource scarcity in the interim."

Under the hood

But Anthony Arefian, director of global markets research at Los Angeles Capital Management, offers a similar sceptical view

Human nature needs stories to explain things, not data.

David Jane, Premier Miton

The broad majority of investors leap onto a narrative to explain price movements.

Paul Flood, Newton Investment Management

when it comes to the narrative-driven markets idea. "We absolutely appreciate that narratives can and do drive sentiment and price action, but it's usually initial price action that creates the narrative to begin with," he says.

"As everyone knows, the market is forward-looking," Arefian adds. "It can take months if not quarters before the justification for price action today becomes clear to investors. For example, global equities bottomed in Q4 2022, and continued to behave strongly into 2023 while investors still feared a 'hard landing'."

It does appear that the risk of a hard landing has declined materially, hence the strong year-to-date performance in equities. But Arefian offers a caveat here. "While a hard landing might be off the table, investors aren't completely convinced that we are beginning a new economic boom or anything resembling one."

This becomes obvious when you go 'under the hood' in equities, Arefian says. "For example, small cap and micro-cap stocks have lagged their large cap counterparts quite badly."

He also shares Jane's analysis in bigging up particular blue-chip stocks. "The performance of the magnificent seven imply that investors are hiding behind the highest quality, monopoly-like businesses, as we navigate this uncertain economic environment," Arefian says.

The magnificent seven

Inevitably, inflation keeps rearing its head in the narrative driven markets outlook. Arefian sees investor concerns shifting from worries about inflation to preferences for structural growth as we potentially enter the late stages of the economic cycle.

"2022 was all about inflation, which benefits companies with high operating leverage," he says. "We noted that use of the term inflation by management teams during earnings calls skyrocketed in 2022, peaking in Q3 2022. It has since fallen off sharply." In 2023, he believes investors have been looking for quality, reasonably priced growth and stable cashflows. "While a recession hasn't materialised yet, we believe that investors are nevertheless seeking large companies with quality assets and management teams, and those with the ability to grow cashflows regardless of where we are in the economic cycle," he says. "This is not indicative of behaviour during a renewed economic boom."

However, Arefian says this does not mean a preference for defensives today, as interest-rate sensitive utilities, staples and real estate investment trusts (REITs) have underperformed as rates have risen higher.

"Economically sensitive small caps have also underperformed – again, not indicative of economic strength looking ahead, and broad indices have been carried by the 'magnificent seven' – Apple, Amazon, Alphabet, Meta, Nvidia, Tesla and Microsoft – which accounted for 60% of the ACWI's 10.5% year-to-date gain through September."

This puts a strong case for investors to look at a large caps narrative. "Many of the largest companies in the US have large positive net cash positions and, in this respect, can benefit from rising rates," Arefian says.

Developing world

Some of the drivers of narratives are the on-going changes in the way the world is developing. Paul Flood says technology is at the heart of the narrative-driven markets idea.

"Narrative-driven markets are part of our digital driven world," he says. "We used to have a lot more time before information was fed through to people. Now it is on X [formerly Twitter], and other social media, and people become more aware of it. People then get excited or panic. This then acts as a big narrative driver."

Then stocks themselves get in on the narrative-driving act with their own narrative to promote themselves to investors. "Within the growth part of the market you get all the main stocks doing this," he says. "CEOs have become more aware of the brand value that they have with their products which leads on to their own stock presenting narratives."

This presents an important question: are the narratives in markets today primarily technology driven? "It is both the speed and the velocity of information," Flood says. "You are constantly moving from one thing to the next. That changes the way investors think, and then react."

But not all investors play by those rules. Flood says he tries to ignore the noisier narratives. "We have generally a low portfolio turnover," he says.But there is a big proviso here, where the narrative noise can be unsettling. "There is a behavioural side to the job as well, and if you are constantly being fed negative news stories there is a point where you begin to question your investment philosophy and process," Flood says.

No value

Looking at the big narrative influences in recent years, Flood says: "Over the last decade, it has been all about growth. Value hasn't worked. Or if you weren't in the technology stocks and mega caps, then it was painful.

"That changed the positions many investors had in their portfolios. Long duration worked, then in 2022 it didn't. It was very painful that year."

Flood advises pension funds caught up in a narrative, to stick with a long-term view. "To an extent, pension funds can avoid the noise," he says, before adding: "But if you underperform for too long, eventually someone gets sacked and then someone else is brought in who has done well. So even in the pensions industry investments can come under pressure from narratives."

Flood offers investors advice in dealing with the narrative challenges. "Being diversified helps you to deal with the bumps in the road."

He also says investors can exploit the accepted narrative by stepping into it and taking a different, contrarian, sometimes opposite approach. For example, when things are negative in the market, look at where the investment opportunities are, irrespective of what the narrative is saying. This could be seen as something of a counter narrative approach. "It is about getting to the facts," Flood says.

"The narrative is a story, but we want to deal in facts. As it is the facts that will determine the long-term returns. Whereas the narrative is usually about the short-term trends in the market," he adds.

Central control

Returning to an important narrative, Flood questions if central banks can maintain control over inflation. "Our view is that over the last two decades, central banks have not had control over inflation. "It has been down to China and deglobalisation that led to a deflationary force and kept inflation in developed markets down," he adds. "We are going to a slightly higher level of inflation going forward."

Here Flood highlights the shifting ebb and flow of recent narratives. "We went from hard to soft landing to no landing. And what I would say, is all narratives do is justify a particular position in the market.

"And an important question is: does the narrative get placed on after the events have evolved? It has to start somewhere. But, of course, there is always some truth in a narrative, because that is why it resonates with lots of people and becomes a narrative in the first place," he adds.

Flood offers another interpretation to the narrative-driven markets idea. "It is a bit like fiction versus non-fiction," he says. "Fiction is your enjoyment and your non-fiction is facts. You should invest on a non-fiction basis."

But interestingly, some investments are driven solely by narratives. Jose Pellicer, global head of investment strategy at M&G real estate, says: "Commercial real estate is entirely narrative driven. And has always been narrative driven. It is how real estate operates.

"The key reason for this is the different dynamics affecting the market. It is not about the short term, everything is long term," he adds. "And driving that long-term outlook is a narrative about real estate and what is does [for investors]."

This offers a completely different take on narrative-driven markets, one where the narrative creates a long-term investment rather than a short-term trend, as is usually the case with narratives in the market.

Your truth

But narratives inevitably can also be problematic for investors. "Narratives create bubbles," Flood says. "They are always there in the market: it is greed and fear. What you need to make sure is you are not exposed to either. Too much greed or fear is something to avoid."

Flood concludes by offering a philosophical approach to the whole narratives idea. "The point is, the narrative isn't the truth," Flood says.

"The narrative is something to raise attention to something in the market," he adds. "And the narrative can be overplayed or underplayed. To avoid being caught up in that, you have to have a process and a philosophy. This doesn't work all the time. As investors you have to take an approach that best meets the circumstances."

Narratives are therefore shaping investment decisions whether covertly or overtly, and will no doubt continue to do so for many years to come.

Narratives are basically shorthand for explaining what are highly complex systems.

David Jane, Premier Miton

DISCUSSION: DEFINED CONTRIBUTION

Auto-enrolment has revolutionised the British pensions landscape. More than a decade after it became mandatory for workers to save into a defined contribution scheme, one master trust has to put around £400m worth of contributions to work in the markets every month.
This highlights how important defined contribution has become. It is also maturing as a retirement solution, given how schemes are applying issues such as sustainability to their strategies.
To find out how defined contribution schemes are investing their capital and managing their assets, we assembled a panel of insiders from across the investment chain to sit down and discuss the issues impacting the industry.

What are defined contribution schemes investing in?

James Lawrence: We are looking at a few areas within private markets. Green infrastructure, venture capital and natural capital are the biggest asset classes for us right now, but it's probably a 12-to-18-month project to get those off the ground.

Emma Matthews: We are going through our triannual strategic investment review, so we are looking at the assets we are managing and how best to allocate over the long term. For example, private markets are topical with the Mansion House reforms, so we are potentially going to make some commitments there.

Roger Mattingly: The Cushon Master Trust seeded Schroders' Long-Term Asset Fund (LTAF) in March, which was the first to be approved by the Financial Conduct Authority. Up to 15% of the assets will be invested in private equity, infrastructure and natural capital.

The other 75% of the scheme is invested through Macquarie in a customised index. This is about reducing our Scope 1 and 2 emissions. The intention is to include Scope 3 emissions as soon as practicable.

Paul, where are the schemes you work with looking for value?

Paul Brain: Last year was a watershed in that we are now in a different environment. We are going to be sitting with higher inflation, which means higher cash rates. The risk-free rate bar has been raised and a lot of investors are judging their assets with a higher cost of capital.

There have also been significant problems with liquidity. This suggests that you need a liquid complement as you move towards higher returning assets, which tends to push you towards private assets.

It is adjusting to the new regime. It is recognising that a 60/40 approach now needs to be a balance of liquidity, of alpha generators and perhaps exposure to some less correlated assets.

Mary, what are investors looking for in this new regime?

Mary Cahani: Part of my job is speaking to key stakeholders in the DC space to understand their challenges. One of those is investing in the asset classes that provide diversification and extra return, be that at higher costs.

Additionally, many stakeholders are asking if the 60/40 split is still valid and questioning the passive approach to asset allocation. Are there other ways to enhance return and can they get that

exposure with ESG integration in a more cost-effective manner?

How has what DC trustees want from their default strategies changed?

Martyn James: Trustees have been looking at their portfolios in the wake of 2022, where performance was hit in pretty much all asset classes. DC investors are long-term investors, so generally clients are not making knee-jerk reactions. They are looking at the glide path and how much risk they should take for younger members and the asset allocation as members approach retirement. For example, some plans have a proportion of defensive assets in the 'growth phase' which didn't perform well, so it is deciding if that is still the right philosophy going forward. For some it will be, others may prefer a different approach.

Andrew, what are schemes asking for when building a bespoke strategy?

Andrew Hope: In terms of bespoke versus off-the-shelf, it is an interesting time. Trustees are becoming more interested in accessing things like private markets. But there are some fairly large operational hurdles for integrating these assets within a bespoke solution, so we are not there yet.

We are looking at what we can leverage without losing sight of trustees needing something specific for their membership.

Trustees can take more risk at certain times and have tended to have a pure equity growth phase, whereas some of the off-the-shelf designs tend to have a take more modest risk through multi-asset approach. When taking higher risk to seek higher returns, it's looking at what that equity bucket looks like that's important. Performance has been driven by a small number of stocks, so what does that concentration risk look like? And even if we are accessing more traditional asset classes, are they providing diversification? These are interesting times.

Lawrence: We are having a similar debate internally. Every product we build has the same concentration risk because we look at assets that are low carbon. I would be interested in a way around that without being too active in our stock selection.

Hope: We have trustee boards, which are effectively capping their largest stocks and distributing that allocation across the market. That has been one approach.

To the point of what impact ESG has on allocations: again, it tends to exacerbate that concentration risk. That is definitely something to be mindful of.

Members have been used to low fees, but that is reflected in their outcomes.

Mary Cahani
Director, UK Institutional
Invesco EMEA

Cahani: In the conversations we are having, most trustees are concerned about concentration risk. The Mansion House reforms allude to a lot more concentration if you focus on the UK alone when allocating to Illiquids and not necessarily the best value-add propositions for members.

There is a lot to be said for having a semi-active approach to the already passive equity exposure that DC schemes have. For example, passive enhanced strategies can operate under similar fee structures as existing standard passive solutions whilst delivering a client an investment experience akin to active management in terms of sustainability. This could be a sweet spot for many schemes, looking to manage costs but at the same time having an active approach when it comes to sustainability goals.

James: There is a heavy weighting to equities, so you are going to have a concentration issue. But to get diversification with illiquids, there is the issue that fees will increase.

Currently, our master trust and some of our clients consider allocations to REITs and other listed real assets. They are not perfect, and potentially we would rather get that exposure from elsewhere, but meaningful allocations to those assets do help with the diversification issue.

Matthews: It is interesting because we are coming into a period which, even for government bonds, is far more attractive than we have seen in a long time. We saw in 2022 how painful those assets can be, especially if they are being held for members approaching retirement. But we have gone from interest rates being 0.1% to where they are now, which is far, far higher.

Lawrence: There's going to be a lot of forced defined benefit sellers in the next few years. There will be a big opportunity for DC, not just in gilts, but also in private equity and other illiquids.

Brain: I'm glad you mentioned that because in 2022 there was a significant move in interest rates, which led to all the correlation changes. But let's not just judge all portfolios on that one year because that happens every now and then. Once it has happened, the new reinvestment rate – whether it is cash, gilts or corporate bonds – has a much more attractive risk/reward.

Two years ago, there was no income and we had to chase illiquids. Now, there is plenty of income in the liquid market. And it may be an income that is more attractive with less volatility going forward.

We are not out of the woods. Regime change means that we are still going to see inflation. It will bounce around a bit, but it is not going to be at 2%. Interest rates will stay high, which means that income levels will stay high.

Cahani: Fixed income is passive in most default portfolios. In defined benefit, fixed income exposure can be both global and actively managed for the contractual-cashflow matching approach. Should there be a similar approach to DC fixed income investing, without the cashflow matching component?

Lawrence: All of our default fixed income is active, but it depends on the master trust. It has traditionally been that those who can find more fee budget, tend to use it on fixed income because it is a good place to be active.

Brain: A large chunk of defined benefit assets are stuck in government bonds, which is the bit that is likely to shrink. A

lot of people have moved to a multi-asset credit approach because it adds diversification.

Mattingly: A reduction in interest rate sensitivities has been on the agenda for the last 12 months or so. What hit everybody last year was the compulsory purchasing of annuities ending, because post freedom and choice there was no longer the direct correlation between the price of bonds and the payment of benefits, unless an annuity is purchased.

Bonds plummeting as people were about to take their benefit wasn't a problem until that relationship was broken in 2015 when freedom of choice came in, and all for good reasons in terms of flexibility, versatility and customisation of income stream.

James: There is certainly an argument to be invested in bonds for individuals taking an annuity when they retire, but a lot of members will potentially still be investing in retirement for another 20 to 30 years. And it is debatable whether they should have a significant amount of bonds in the pre-retirement phase.

Mattingly: You are assuming the pot sizes are sufficiently large to drawdown on, whereas the average minimum auto-enrolment pot is £5,000 to £6,000. They are not going to drawdown from that, so they will almost certainly take it as cash and will have been realising those bond value reductions.

Hope: Coming back to off-the-shelf designs, most have to be appropriate for a range of people. How do we do this, while still ensuring the design is supporting good outcomes for all?

Matthews: It is challenging. At Now Pensions, we have a broad membership. We do a lot of work with gig economy workers, who might not be consistent in their savings journey. And you have to be mindful of members who are in their 20s and have only been contributing for a couple of years.

The picture we typically build is that our members generally take a cash lump sum at retirement. Having that debt duration in the portfolio simply does not make sense for a person who then takes cash.

Cahani: Decumulation is one of the hardest problems people are grappling with. How much work is being done for members who have £50,000 to get a proposition that will keep their lights on?

We are doing a lot of work in this space to understand further the needs and wants of the members. The outcome of most conversations comes to them needing longevity protection through the annuity piece but at the same time they would like to sweat their assets a bit more during their early retirement, eluding to a need for a combination of annuities and some growth as a post-retirement solution.

The government wants DC schemes to fund the upgrade and repair of Britain's infrastructure. Are they putting assets in front of you to invest in?

Brain: No. It is something that is going to come, because it has to. The direction by the government towards pensions to shoulder the investment burden in the economy is something that is going to come through, whether it is infrastructure or something else.

We have seen it before, but it was halfhearted. There are economies in Europe where there is greater emphasis on that, but it is not happening at a significant scale in the UK yet.

We are not going to be the government's coffers.

James Lawrence
Head of investment proposition
Smart Pension

What I'm alluding to is that the UK government doesn't have sufficient money. There have been too many incentives aimed towards achieving net zero. It needs to switch to the 'stick' rather than the 'carrot' approach: decarbonisation has to be taxed.

Are asset owners interested in infrastructure?

Lawrence: Yes, very much so. We are mainly looking at renewables. It is probably going to be global; we are not going to be the government's coffers.

There are lots of opportunities across Europe in the green infrastructure space. We are interested in Spain and looking at batteries, solar and wind.

Matthews: Cost is a consideration for master trusts. How do you overcome that challenge?

Lawrence: We have to be innovative. There are some managers who are willing to play in this space at good fee levels. There is not much capacity in those managers, so there's probably some good deals to be had quickly.

Roger talked about Macquarie's index; that is probably going to be the way forward for many DC schemes along with the structured equity piece. You go from paying low single-digit basis points for equity to zero or negative fees. That is going to open up.

Hope: We are at a crossroads in terms of absolute charges versus value. Within our *2023 DC Pensions and Savings* survey, we found that the appetite for trustees and sponsors to pay more to access some of these asset classes is low.

There is going to have to be a shift, and some regulatory pressures in terms of value for members to help drive this shift. But we need to fundamentally move towards a perception of value rather than absolute cost.

The margins which master trusts look at are fairly small and to make some of these allocations meaningful, we have to accept the increase in charges; we can't just focus on cheap passive assets. There needs to be repositioning from that.

Lawrence: The problem is we have been saying that for about five years.

James: Do you not feel there has been a bit of a sea change?

Lawrence: Not significantly. We are not increasing our prices, which is what we need to do, but we are not decreasing them as rapidly as we have done.

James: Fees are a big issue when a company considers a master trust for their employees and we are seeing a lot of competitive pressure on fees. When considering infrastructure and other illiquid investments, our master trust is considering how to get illiquid investments into the master trust at an appropriate fee level. There needs to be a sea change with third-party evaluators and then the clients buying master trusts with respect to fees if we are to see more in illiquids.

With the value for money consultation and the Mansion House Compact, I do potentially see things changing. How quickly behaviours will change, I'm not sure. But there is a change in the air and hopefully from 2024, there might be an acceptance for higher fees in master trusts to pay for illiquid investments. Clients might be buying those who venture first into this space, but it remains to be seen.

Hope: I share your optimism. One of the big fundamental shifts in value for members is around the disclosure of net performance, rather than just explicit charges. If we are focusing on net performance around adding value to members' pots, the charges get pushed to one side if the net performance is better.

I take your point. We have been talking about this for a while, but we are reaching a critical point where I'm not sure the charges can be squeezed any further. Ultimately, it feels like we are going to see

something changing over the next couple of years. It might take a while, but we are getting there.

Matthews: Fees are, of course, important but as a typical master trust accumulates assets, there comes a tipping point of being able to start allocating to get that diversification. When you are going into illiquid assets, that is incredibly important.

Cahani: There are ways around the charge cap. Members have been used to low fees, but that is reflected in their outcomes. Surveys show that members want to find a cost-effective way as diversification is important to them.

Speaking from where we are with markets, private equity supposedly is not the most effective way of deploying assets at the moment. In private debt, due to interest rate movements, you could effectively make the same return for a lower cost.

For Invesco, as an asset manager, there has been a lot of listening and we are working on designing active, customisable investment solutions.

Lawrence: It depends where you invest. There are big opportunities in VC.

Cahani: Yes, but it is better to be a lender right now than an investor.

Brain: There is a note of caution to be sounded here. Are they tested through a proper economic cycle? One of the consequences of higher interest rates is that you get more economic volatility, more 'boom and bust', as well as more inflation.

We are coming into a period which, even for government bonds, is far more attractive than we have seen in a long time.

Emma Matthews
Head of investment
Now Pensions

Liquidity is one thing, but default is another story. Your capital can evaporate fairly rapidly if we go through a period of significant economic stress, which is coming. So you will need to balance your private assets with liquid assets.

The other issue is that a passive investment is a way of delivering a solution at a cheaper price, but it is a beta play. Active investment costs more and the challenge for us is to deliver active investment at a competitive price. One that gives the clients access to that regime change backdrop while delivering more than just the beta.

Pressure should be put on the private market providers to create a charging structure that is more palatable to master trusts.

Roger Mattingly
Trustee director
Independent Governance Group

On the subject of fees, has regulation been a help or a hindrance?

Mattingly: Performance-related fees are an issue. We were going to involve a particular sustainable energy company in the illiquid exposure of the Cushion Master Trust but there was an insistence on performance-related fees, which excluded them from that strategy.

From a regulatory perspective, the pressure should be put on the private market providers to create a charging structure that is more palatable to master trusts.

In DC there is a massive scramble for assets. Over the next 10 years, 10, maybe 15, master trusts could possibility have £1trn between them. So the prize for private market providers is huge.

Rather than putting the changes to regulation on the side of schemes fitting in with the private market charging structure, it should have been done the other way around: the challenge should have been to private markets saying that this market is going to be absolutely huge and there is a desire to have uncorrelated and diversified assets, to have significantly higher attributions to private markets, so can you make your charges more palatable? And that may be to recognise the complexity and the specifics of some products.

Performance-related fees are an issue. It is causing a problem.

Matthews: I will second that. I get the benefit of performance fees elsewhere in the market, but with DC, when its member assets, when you are pricing regularly, the mechanism for implementation is difficult to justify and make sure you are treating all of your members fairly.

Cahani: One of the main fiduciary duties trustees have is making sure that if you

are paying fees, you are getting the return. If young members are part of that, and people in their 50s are doing the same, they are not going to have the same investment power.

Mattingly: It causes a fiduciary problem.

James: Can I play devil's advocate? We look at Australia as the future and they invest in illiquid assets and are willing to pay higher fees looking for stronger net of fees performance.

Lawrence: It is a journey. There are enough operational issues with getting these assets in without performance-based fees being another. There are managers out there that understand the issues and are willing to go with lower fees, or maybe without performance-based fees, just to get into the market early.

Things may change over time, but it is an issue. Performance-based fees would be another headache, which wouldn't be overcome by most master trusts or DC plans right now. Perhaps, as things mature, they could come back if demand is there.

Cahani: Conversations are happening in this space. Master trusts and pension schemes are asking us to show them what a mandate would look like with and without performance fees.

We are grappling with this when it comes to the value proposition for the client and implementation challenges.

Lawrence: Presumably, when you build something without a performance fee to co-invest in secondaries, there are pros and cons to that.

Cahani: Or if you include alternatives that don't charge performance fees. A number of schemes are looking to have liquidity built within an LTAF structure based on the platforms they use. In these cases, you are looking at a weighted-average fee of the LTAF, which leaves some room for movement.

What are the big barriers to making DC portfolios more sustainable?

Matthews: It's a challenge. It is about finding the right balance between allocation and engagements. It is something that has evolved materially over the last few years. That has expanded our equity exposures, which are tilted towards lower emissions, but also recognising that the transition and allocation alone are not going to solve the problem.

If you disinvest from something that has terrible carbon emissions, they are still going to be emitting. We are trying to find that balance, engaging and looking at how we can leverage our investment managers on the equity side as well as what we can do with bond issuers to further that journey.

Lawrence: We discuss it at every trustee meeting in significant depth. The governance required to do this properly is difficult, especially as we have biodiversity in our default fund and TNFD is coming up, which is going to be another layer of scrutiny and intensity on master trusts.

We have just implemented trustee-directed voting. We are probably not going to give our members 1,000 votes a year, but we will give them a voice on the biggest votes, Shell and BP, etc. Where stewardship sits is a big discussion.

Hope: The regulations are putting more onus on trustees. We are finding that trustees are feeling a little bit helpless in the sense that there are a number of layers to get through. A lot of them are invested in pooled passive funds and then through to the managers involved. Trustees want, and in some cases due to scale must, delegate a lot to the investment managers.

The real problem is the work investment managers, particularly passive managers, need to be doing is through meaningful engagement with the underlying hold-

There will be a greater focus on the natural costs of sustainability going forward.

Paul Brain
Deputy CIO of multi-asset
Newton Investment Management

ings across the board. There needs to be an exponential growth in these engagements from stewardship teams. Trustees appreciate that it is an issue but are feeling a little caught in the middle.

Matthews: It is also prioritisation. There are a million and one things that we could do, but it comes back to: how do we fight the right fight.

What are the big sustainability issues that we are talking about here?

Matthews: For us, we have gone back to looking at what is important. We are balancing the environmental side as well as the social side. I mentioned gig economy workers, so when we engage, we are not just looking at climate change and biodiversity, but also at gender equality and living wages and how do we fight those fights for our members, while still acting within our fiduciary duty.

Brain: We spent a lot of time making sure that on the fixed-income side we have a voice in the stewardship engagement. And because we invest in investment grade and high yield, we have more access to companies than some of our equity investors. It is surprising how many times we engage with companies.

If we don't like what we see, if they don't have the right diversity mix on the board, for example, we can tell them why we are not going to invest in their bonds. We get a lot of changes through that way. We don't have a vote, but you would have to be quite a big equity investor to change the direction of the company.

If you can work with them to coerce them in the right direction, then you have used that capital in a sustainable way.

Cahani: When it comes to sustainability, you have to consider an adaptive approach over the long term.

For example, we are looking at how an active illiquid approach to fixed income can adapt the portfolio over time to be net zero, or a certain targeted sustainability goal that they have. It's an adaptation over the long run.

Brain: To add to that, we have so many different tools because we invest in different levels of the capital structure. We are not just buying listed equities. We can buy sustainability-linked bonds or green bonds and we can engage with the company and get them to change their standard issues as well.

James: Taking a slightly different tact, I have been told that from our RITE survey, 60% of our DC clients have an ESG fund in their default, which is positive. It is likely to be a passive global equity index, but it's a good step.

We talked about barriers. Fees are higher for active funds looking for a positive impact in companies looking at climate change, etc, and therefore are generally only available as self-select funds.

As well as making the world a better place, asset managers have to make money for their clients. How are investment managers helping schemes to earn value from the energy transition?

Cahani: On the equities side, we know that a number of DC schemes, sponsor and master trust led, are targeting net zero by 2035 and 2050. This is a moving target and you are not expected to meet this through a passive approach to investing.

A lot of the conversations we have are about adding that active layer to the existing application, basically an active tilt to a

passive portfolio for performance enhancement or ESG goals.

Some interesting trends have emerged around commodity ETFs. Instead of as an inflation hedge, they are being used as an asset-transitioning tool. If your assets are in transit, or you are waiting to deploy a bulk of assets over time, a custom-made allocation to such a proposition can target certain ESG goals.

When you think commodities, you think carbon, but you can include a reduced carbon approach to that allocation. That is a trend we have seen emerge in that space.

Matthews: We historically had oil exposure, but we removed it a while ago to look at commodities and how different commodities can support the green transition and the journey to net zero.

Cahani: It is interesting how many positive trends have emerged in this space. We did a session on this last week, and I was surprised at how you can positively tilt an energy allocation in terms of returns.

Matthews: When we get to 2050, we will need to build new homes and we will still need electricity. We have to be mindful on how we incorporate that into the journey.

Mattingly: The great thing about large master trusts is they can have an almost infinite time horizon. So liquidity is pretty illusory and should not be a barrier to the world of private markets and sustainable energy.

This requires incredible discipline on the operational side. It is okay if you have many millions of pounds coming in every month but there is a lock in period of three years which needs to be navigated, and you need a lot of stress testing in terms of market changes to make sure you always have enough money to pay benefits.

With the DC population, there will be an inflection point when it becomes a mature population. At the moment, it's not. Across the board, it is a pretty immature population in terms of membership across master trusts.

Trustees have to check it against financial materiality. That is difficult when you have the Ukraine and Russia situation almost artificially inflating market prices of certain fossil fuel energy companies. You have to continue with the belief that those companies that take the transition physical risks of climate change seriously and risk manage those that they will outperform in the medium to long term.

Hope: On the financial materiality point, the difficulty with these funds is that they have short historical performances. It is one thing me talking to them about empirical evidence, but how is this playing out?

We had an unusual 2022, but surveying the membership gave trustees comfort. The member responses are probably the one area where I have been enthused by the level of engagement, with up to 60% to 70% of the membership responding. We even asked if they would pay more or retire later if you were to invest in a sustainable way.

We had some positive responses, but the responses tend to be quite heavily correlated by age. As people get closer to retirement, their willingness to pay more or retire later diminishes.

I started this discussion by asking each of the asset owners around the table what they want to invest in. All three said natural capital. Why is it so popular?

Lawrence: Inflation protection is a big piece of that. Biodiversity credits are going to be big as well, so we are getting ahead of that journey. It is also a great member engagement story. It is a pretty under-invested market, so there is an opportunity.

Mattingly: It is horribly complex. There are the carbon markets and sequestration, and then there is deforestation. The irony is that making wind turbines, until fairly recently, decimated forests in Columbia in the process. The more you delve and the more you get to grips with this, the more you realise that you are not getting to grips with it. It is a three-dimensional simultaneous equation.

We need to fundamentally move towards a perception of value rather than absolute cost.

Andrew Hope
Director
Willis Towers Watson

There is a lot of consolidation in the DC market. Is that helping?

Brain: In the investment management industry, consolidation is a natural consequence of the fee pressure. Active managers have to deliver products at ever lower costs to the investor, and naturally, that leads to consolidation.

That will only go so far, because you don't want to lose the ability to generate alpha. Unfortunately, if you squeeze it too much you end up with supermarkets which don't deliver alpha. We may be getting

There is a change in the air and hopefully from 2024, there might be an acceptance for higher fees in master trusts to pay for illiquid investments.

Martyn James
Partner, DC and DB investment specialist
Mercer

close to that point, but we probably have a couple more years of consolidation to get through.

Cahani: Schemes, be that master trust or sponsor-led, are grappling with the same issues: sustainability, fee compression and consolidation. They will impact the propositions that come to market and how we handle conversations with clients.

The biggest shift that is going to come through consolidation is we are going to see more of a partnership approach. You will see DC schemes and master trusts working closely with asset managers and platforms to create more holistic propositions.

What will be the next big development in DC?

Brain: A realisation about sustainability and its costs. The transition comes at a cost in many ways. In every large investment cycle, there has been an awful lot of wastage of previous capital, and then there is a lot of wastage of natural resources to come up with new capital. We need to judge that more clearly. Unfortunately, the regulation we were coping with does not necessarily help us do that.

What we as investors need to do is lift the lid a little more on electric vehicles. The batteries are great, but how are we creating them? What damage does it do to the environment? Is there a better way?

There will be a greater focus on the natural costs of sustainability going forward.

What are the big investment challenges for DC going forward?

Hope: One area where there is going to be some focus is post-retirement and what those designs look like in this pensions freedom world.

How people access their funds and what they are going to do about long-term care will decide what the investment designs will look like through to retirement. That is definitely going to be an area of focus for master trusts and trustees.

Matthews: Post-retirement development is essential. We cater from the day someone becomes a member all the way to retirement. It surprised me when learning about master trusts for the first time, that we didn't cater for it all the way through. We should be developing something to do that.

Cahani: I came here from a meeting on the same topic. We are going to see access enablers that can bring together propositions for schemes and master trusts to enable access to asset managers in a simplified method.

A few are already doing that, but we will see more of them emerge.

Matthews: Do you need a platform? Could you just build it yourself and remove that cost?

Cahani: Master trusts and pension schemes can do it, but it is about enabling access because members may not want to stay with their master trust upon retirement.

Providing that flexibility to choose the proposition. Here are the tools, here is the platform you can design on your wants and needs, they can do a glide path with drawdown protection, as well as keep the lights on with annuities. Bringing those propositions through to members via a platform is quite powerful because it gives them choice but also some guidance.

Sometimes it is a fine line between advice and guidance. The best way trustees can facilitate this is through giving them guidance towards the right enablers for this.

James: There are other issues post-retirement. There is potential for Collective Defined Contribution [CDC], for example. Also, as another example, we have a solution which provides digital and regulated advice to all individuals regardless of pot size, not just at retirement, but in retirement as well.

This means their investment allocation is looked after right the way through retirement, so there definitely are some interesting innovations in this area and there are some exciting new areas to look at.

pi ESG CLUB

Pollution and inequality have made emerging markets an ESG nightmare. But with growth forecasts for developing economies outstripping those for the developed world, this month's ESG Club looks at how investors are aligning the need for a return with their responsible investment policies.

Members

IS ESG FACING A BACKLASH?

ESG is facing a backlash on many fronts, and seemingly led by the prime minister. But all is not lost for investors, finds *Andrew Holt*.

Environmental, social and governance (ESG) has been central to how institutional investors manage their investment portfolios for some years, but it is coming under pressure in some quarters.

Prime minister Rishi Sunak has backtracked big time on the government's climate commitments in the face of the rising cost of living, which has seen some pushback from investors.

Investors and the CEOs of the UK Sustainable Investment Finance Association (UKSIF), the Institutional Investors Group on Climate Change (IIGCC) and the Principles for Responsible Investment (PRI), penned a letter to Sunak, focusing on the importance of an 'enabling policy environment' so investors can make long-term investment decisions.

It added that a delay to key targets risks the UK missing out on investment to other regions and nations that are taking a more consistent, long-term approach.

Clarity and consistency

James Alexander, chief executive of UKSIF, set out the importance of clarity surrounding ESG. "With his background in financial services, the prime minister knows how important it is that investors get clarity and consistency from government if they are to choose to invest at scale in this country," he said.

Alexander then added: "The UK is already at risk of falling behind other countries, who are forging ahead with huge incentives to accelerate net-zero investment, and the PM's speech may only make matters worse.

"We urge him to reconsider his watering down of a number of climate change commitments, including the pushing back of the electric vehicle target, so that we do not miss out on the transformative investments needed to get to net-zero by 2050."

Investor confidence

Putting the position of the IIGCC, chief executive Stephanie Pfeifer pointed to maintaining investor interest on the issue. "Investor confidence is crucial to the UK being able to enjoy the economic opportunities presented by the net-zero transition, including investment and the jobs that brings," she said.

"By backtracking on climate commitments, or taking steps that put into question whether the UK will deliver on its legislative long-term commitment to net-zero, the government's announcement risks undermining this confidence."

David Atkin, chief executive of PRI, also fired a warning over Sunak's decision. "The entire global economy – including the UK, its workers and communities – stands to benefit tremendously from a continued and accelerating transition to net-zero," he said.

Indeed, analysis by the CBI earlier this year indicated an up to £57bn boost to UK economic growth by 2030 if the government accelerates progress on net zero.

"To secure these benefits, the UK government must not abandon its ambition on this vitally important topic. Investors remain committed to action on net zero and clearly recognise the benefits of doing so," Atkin added.

It is now incumbent on the UK government, Atkin said, to "mirror this ambition" and take steps to "deliver the benefits of a net-zero economy to the investment community and the country at large".

It is self-evident that if the government cannot lead on ESG and climate change why should institutional investors follow?

So does this scepticism towards ESG equate to an ESG backlash? Indeed, this has been something that investors and others have discussed for some time. If so, the debate surrounding ESG is probably taking place at a quicker pace in the US, where the issue has become something of a political football. Particularly among some Republicans, who kick it around at will in an attempt to gain public support to stop its march. Sunak could be well be following this tactic.

ESG is missing

In a sign that there is a wind of change on ESG, the US Securities and Exchange Commission, in a surprising move, omitted ESG from in its 2024 Examination Priorities Report.

Instead, the report said its examinations will prioritise "areas that pose emerging risks to investors" or the "markets in addition to core and perennial risk areas". The fact that a US regulator felt the need to do this speaks volumes.

In addition, global think tank and business membership organisation the Conference Board surveyed more than 100 large US companies, which revealed that almost half have experienced an ESG backlash, with 61% expect it to persist or intensify in the next two years. So on this evidence the ESG backlash is real and being felt by corporations.

That said, it is not all one-way traffic. As corporates seem to be doubling down on ESG rather than letting it go. Indeed, most companies (63%) said they are increasing their focus on the business case for ESG.

This could then in fact be good for investors, who could expect companies to present a greater coherent, cohesive narrative of their company's strategy involving ESG.

In other words, to have a business strategy that is sustainable, not just a separate sustainability strategy. This would be an advancement of ESG, not a retreat. So out of a challenging ESG environment, could spring some real investor benefits.

INTERVIEW – CLAIRE CURTIN

"The social aspects have potentially suffered at the expense of a narrow-minded focus on climate."

The Pension Protection Fund's head of ESG and sustainability sits down with *Andrew Holt* to discuss the changing investment universe, stepping out of the E's shadow, the option of last resort and not knowing everything.

How has ESG and responsible investing changed since you joined the Pension Protection Fund (PPF) in 2018?

I joined from an ESG data provider where I spent years convincing pension funds and asset managers that ESG is critical. Having seen a slow take up, the launch of the Task Force on Climate-related Financial Disclosures (TCFD) in 2015 saw a massive shift in the industry, and not just around climate.

UK pension funds have also seen measurable change in their reporting thanks to regulation. This is the oversight that we, as an asset owner, should have.

That is probably one of the biggest changes I have seen: that expectation, particularly from larger asset owners, about what we should be doing to continue overseeing and standing by our values and commitments on ESG.

Has ESG grown in importance as an issue during the past couple of years, or have you seen a gradual change?

It has been gradual, and definitely not linear, but suddenly in the last two years we have seen a big pick up. The number of organisations involved in working groups has significantly increased. The sheer numbers of attendees at the responsible investment roundtable we join forces with quarterly has grown. And that's mainly been in the last couple of years.

I would have struggled to have a detailed conversation with some of these groups two to three years ago, but we have much more thorough conversations now.

What is the PPF's approach to ESG and responsible investing?

We have been thinking about responsible investment pretty much since our inception. That's the benefit of being a younger organisation, you can adopt things from the start.

We were an early signatory to the Principles for Responsible Investment (PRI), and those founding principles have been key for many years. That focus has been on the integration of ESG and thinking about materiality, so that helps emphasise our strategy. We are thinking about the material risk, but also the opportunities. And with that, our focus tends to be more on engagement and trying to improve a company's practices, rather than shifting to a divestment decision. That would be a last resort for us. And driving change in the real economy is what we are trying to push with all of this.

Have you ever implemented that last resort?

We have, in a few specific areas where we feel from a financial perspective that it's no longer a sustainable business. We changed our equity benchmark a couple of years ago and removed a few companies.

From a financial perspective, there wasn't going to be a place for coal in the future, so we started to reduce that exposure.

Do you have something like a three strikes and you're out approach?

Yeah. We have been working on a formal

escalation policy. That's going through our committee approval process and means we can be explicit about the steps that would be needed to progress to that level.

Your climate change report highlighted the many successes of your ESG approach. What were the main findings?

This is our third climate change report. The evolution of the report tells a story. The first was just a narrative, it was the start of the journey. I look at the report we've just published and we are reporting progress, putting more quantitative data and visuals into it, which is great to see.

That in itself is a kind of success: that we've been able to show that evolution. We have tried to include a number of real life examples of our work.

More widely is the work we've been doing on our portfolio alignment assessments. Which again, it is something that has taken a couple of years. It's a multi-year process, and we are definitely not done yet.

When we started there was little out there publicly that we could apply to the types of assets we had. So we had to build a lot of assessments, or make a lot of assumptions and decisions ourselves and try to use data as much as we could.

In the portfolio, what we hold in this asset class is to make it relevant to us rather than a broader top-down assessment, as that is time-consuming, resource intensive and involved lots of debate.

We are starting to see the progress we have tracked over the last couple of years to where the overall distribution of the fund is. It's great to see that.

We have seen an increase in the assets that we can classify as aligned with Paris [Accord] and net zero, but also, coupled with that, a decline in assets that are not aligned. It is not that we have made sizable shifts in the portfolio. The equity benchmark is something we [changed] a couple years ago.

It's about supporting our engagement, rather than a divestment argument, and showing that change. We created a climate watchlist because we cannot monitor everything. This is more than 80 companies and accounts for a substantial amount of our financed emissions in our listed assets. By prioritising our efforts, we can track the progress of those companies.

Why have you set such high responsible investment targets?

A lot of what we've communicated has been driven by the organisational sustainability strategy we published in the summer. We have tried to leverage our development of that and think about who we are as the PPF, the uniqueness of us and our position within the industry, who we work with, partner with, and how we operate.

That's been a real focus for us: thinking about not just sustainability, and not just environmental sustainability, but also the social aspects. Part of our diversity and inclusion strategy is how we utilise our human capital, while also engaging with our stakeholders.

With net zero in particular, the big challenge is how do we achieve [the transition to net zero] in our direct operations, but also how do we achieve it in our supply chain? Before we can see real change, we're going to need more data.

And we're hoping that by talking about it and getting involved with other groups trying to address the same problems, that together it becomes a more comprehensive ambition.

Are you on target with all your ambitions?

Yes. Some of these things are going to take three to five years, or perhaps even 10 years to move towards.

Are there areas where you want the PPF to improve in terms of responsible investment and ESG?

We don't have all the answers. We haven't got it all signed, sealed and delivered. But we want to be more open, sharing the challenges and obviously accept that most people are going to be in the same boat as us. We found that collecting data to report more on Scope 1, Scope 2 and Scope 3 emissions is a challenge.

What are the key initiatives that you feel have shifted the ESG narrative?

The TCFD was absolutely a game changer globally, but the European Union's Sustainable Finance Action Plan has shifted the reporting and the transparency of our European managers.

It's not just thinking about climate as an E issue, but also the social and economic impacts. The just transition narrative has been critical and will be even more so as we start thinking about what it means in emerging economies. Being involved in a transition that creates jobs and levelling up will lead to a better real world outcome.

Where are the ESG failures on an industry, governmental or supranational level?

It is probably quite topical in the UK. That centres around the time-horizon issue. The focus on cost now, versus costs

We have been thinking about responsible investment pretty much since our inception.

tomorrow, and then what is driving decisions that get made.

It's definitely a challenge. We are seeing more at the governmental level globally. But even this is a much broader problem than just what one country will face, and that fairness aspect is always going to be incredibly challenging.

The failure is also possibly more around the way it's being positioned: just focusing on costs and not focusing on the benefits or opportunities.

What have been your biggest challenges in your role and how have you dealt with them?

The sheer breadth of issues and areas that now fall under the ESG-sustainability umbrella can be overwhelming. The ongoing data challenges alongside that standout.

I'm someone who always wants to know more. I always have a desire to know more, to learn more, to understand more. But then you have to prioritise. So the way I deal with it is to have a subconscious re-prioritisation going on in my head.

Alongside that, I need to have patience. Things take time. None of this stuff is going to happen overnight. So it is about being pragmatic as well.

Have you ever felt being a woman in investment has been a barrier in your work? Have you experienced discrimination?

I've always been aware of the imbalance in the industry. The diversity element has been talked about for the 23 years I have been in this area. Of all the areas in asset management, ESG is probably the most diverse and I don't know what has led to that. But potentially, I guess the diversity of issues within ESG has a part to play.

What can the industry do to achieve more on the social side: both when investing and bringing more diverse people into the industry?

The social aspects have potentially suffered at the expense of a narrow-minded focus on climate. So we have been quite heavily involved in the DWP's taskforce on social factors and looking to see it build guidance for asset owners to think more about that side.

It is hard to demonstrate some of the benefits from taking a social lens within the investment consideration. Less data makes it harder to track or even to prove.

A great deal of research tells us much about more diverse teams having much better productivity. And having a more socially diverse group of people is critical. We are looking at it across our recruitment practices. It is crucial to broaden people's minds around the importance of getting a broader mix of people.

Why has the social side been relegated below the environmental aspects of ESG?

I don't know if it is one particular thing. You can only deal with deep diving on one area at a time. But it is the data aspect as well. It's a lot harder to standardise. You have to get into the nuance of knowing what's going on.

What have been the biggest lessons you have learned in your career?

The main lesson is being brave, being open to change, to new themes and new ways of doing things. Alongside that, a thirst for learning and to continue developing yourself. You never know everything.

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EMERGING MARKETS: AN INVESTOR'S DILEMMA

There is a distinctly different flavour to meetings at Oxfordshire County Council these days. In March, councillors voted to ban meat and dairy produce from being served on their premises. Instead, they now tuck into a plant-based menu.

This has not been the council's only move to help protect the environment. Three months later, its pension scheme started reducing its exposure to the extractive names in the FTSE100. But it then went a step further by deciding to dump its entire £80m portfolio of emerging market assets.

This could be seen as a surprising move, given that developing nations are expected to drive most of the world's economic growth in the coming years. Indeed, the IMF predicts that emerging markets will grow by 4% in 2024, led by China, India, Indonesia and Brazil. This is more than double the 1.4% expected from the developed world.

"Despite the uncertainties we have seen in China, emerging market growth is strong, especially compared to developed markets," says Jean Charles Sambor, head of emerging market fixed income at BNP Paribas Asset Management. "In the US and Europe, we are talking about soft or hard landings, while in emerging markets we are seeing some resilience."

This does not appear to be a blip. HSBC predicts that emerging markets could be responsible for 70% of the world's economic growth in 2030. These projections are five years old, but emerg-

Pension schemes need the emerging world's growth, while the emerging world needs pension schemes' capital. But, as *Mark Dunne* reports, they do not make easy bedfellows.

ing markets are growing as expected, and if there is to be a geopolitical-driven downward revision, it will likely hit the developed world just as hard.

But there is a problem. While the emerging world offers high growth potential, it is also home to an abundance of sustainable risks. Indeed, eight countries in Asia are responsible for 45% of the world's carbon emissions, according to impact investor Thomas Lloyd.

The asset class also has big inequality and governance issues, which the Oxfordshire Pension Fund named as a reason why it was looking elsewhere for growth. The scheme has singled out China and Saudi Arabia as particular concerns.

A spokesman for the Oxfordshire Pension Fund told *portfolio institutional* that there are concerns around risks to future investment returns stemming from the governance arrangements around a number of companies, particularly in China. "The future financial risks led the committee to determine they did not wish to increase the specific allocation to emerging markets to a material size."

We can work it out

Many institutional investors are aware of these concerns and, judging by their responsible investment policies, are probably uncomfortable at being exposed to them. Yet their approach is

to work with governments and corporate boardrooms in the developing world to create the sustainable outcomes they are targeting.

One such investor is Nest, which has around 10% of its £31.5bn of assets working in these markets. The master trust works with its fund managers to ensure the assets in each mandate align with its climate change policy.

"We are not looking to reduce our exposure to emerging markets," says Katharina Lindmeier, Nest's senior responsible investment manager. "It is more a case of better understanding the risks, but also the opportunities.

"It is crucial to the transition that we invest in emerging markets," she adds.

Indeed, it is unlikely that climate change can be stopped by just reducing harmful gas emissions in the developed world. Research by economist Nicholas Stern found that $2bn (£1.6bn) a year until 2030 needs to be invested by developing countries, excluding China, to reduce their climate-harming gases and to deal with the impacts of a changing climate. Most of this will have to come from private sources.

The good, the bad and the uncertainty

Yet private capital is not being put to work at the levels needed in the emerging nations of Africa, Asia, the Americas and Eastern Europe. During September, around $13.8bn (£11.3bn) flowed out of such securities, $12bn of which were equities, the Institute of International Finance estimates.

"We have seen outflows from emerging markets on the equity and debt sides," Sambor says. "ESG uncertainties might have triggered some short-term pressures, but it has been something of a sideshow to top down global macro sentiment."

A Fed tightening cycle, geopolitical risk in Ukraine and uncertainty in China have been greater influences over investors' decisions, but sustainability issues could be having more influence over these portfolios.

Sambor says that ESG will play a greater role in how investors pick developing market stocks. "Once we see appetite return to emerging markets, there will be more discrimination between the good and bad ESG countries and companies," he adds.

Slow progress

Once that appetite returns, what outcomes will investors be targeting? Human rights? Reversing deforestation? Providing access to healthcare, education or clean drinking water?

Nest is focused on the energy transition. "It seems easier to focus on climate because there are fairly consistent metrics in terms of emissions," Lindmeier says.

It is harder to define the other ESG issues, such as, for example, what is needed and where in terms of healthcare to improve equality in India. "Whereas with carbon emissions you can see the levels [that] different countries have, what the trend is and which are struggling with the transition," Lindmeier says. And some economies are struggling to decarbonise. China, for example, has re-opened some of its mines despite pledging to achieve carbon neutrality, Sambor notes.

Just because it is difficult to engage with a sovereign is not a reason to not invest.

Katharina Lindmeier, Nest

"On average, emerging markets tend to be more dependent on coal than their developed market peers," he says. "We are seeing attempts to diversify away from that, but progress is slow."

Indeed, more than 90% of new global carbon emissions emanate from emerging markets. "That is more a function of where they stand in their development cycle," Sambor says.

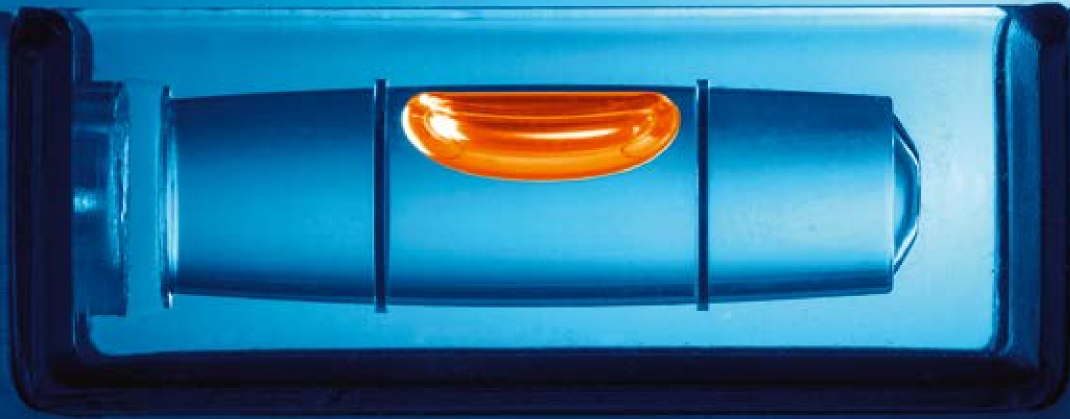
The elephant in the room

So investing in emerging markets responsibly is a challenge, especially with China being so dominant in the asset class.

The world's second largest economy will expand by 4.2% next year, the IMF believes, despite problems in its property market, lower inward investment and weaker consumer spending. Although this is slightly down on the 5% expected for 2023, it beats the 1% projection for the US and the 1.5% in the eurozone. However, China is responsible for around 30% of the world's carbon emissions and is aiming for net zero by 2060, while India has given itself a decade longer before joining them.

So what is a fair pathway for emerging market portfolios to decarbonise, considering that they are dominated by China and India, which have different net-zero targets? "It's not just about their contribution to the transition, but also their physical vulnerability," Lindmeier says.

Here lies another challenge. Getting data on the physical risks of emerging market assets, even equities, is harder than in developed markets "where there are similar trajectories" that investors want to achieve. But the standards of disclosure are improving, Sambor believes.



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"Some emerging market sovereigns and corporates tend to be less transparent than their developed market peers, but we are seeing some improvement," he says. "There is a strong commitment to communicate better and to engage."

Come together

Engagement is important in cleaning up dirty assets and reducing inequality. But how easy is it to change a sovereign's policies? "It is a challenging area," Lindmeier says. "Just because it is difficult to engage with a sovereign is not a reason to not invest.

"We have engaged with state-owned companies and there are challenges. They are always going to pitch their target on what the government has set. In economies that do not have a net-zero target by 2050, it can be challenging to engage with them," Lindmeier says.

Indeed, a large part of the emerging markets space is quasi-sovereign. Being owned by the sovereign means their disclosures are typically weaker. "Engagement is crucial here, way more than in developed markets," Sambor says.

"Success in engaging and tracking ESG in emerging markets requires a lot of commitment and co-ordination between your dedicated individuals and your investment people," he adds.

BNP Paribas AM has a sustainability centre in Singapore, which tracks the ESG profile of its emerging market exposures. "It also requires a local presence to do daily or weekly engagement," Sambor says. "It is not enough to do due diligence twice a year and pretend that the job is done."

But for those with no presence on the ground in emerging nations, understanding if your investments are making the agreed changes could be difficult outside of owning publicly listed companies.

One approach could be to collaborate with local investors when engaging. This could also help with any language barrier. The Church of England, USS, Border to Coast, Brunel Pension Partnership, BT Pension Scheme and Railpen are some of the institutional investors working within collaborative agreements in the emerging world.

Nest has focused its emerging markets stewardship on Climate Action 100+ and has been working with other pension schemes to form a collective voice. It has also joined an emerging market just transition initiative. Identifying the challenges, such as deciding what a fair transition looks like in emerging markets, is part of their work.

For example, if investors have a policy to phase coal out of their portfolios, are they penalising some countries, particularly in Asia? So are investors excluding Indonesia, for example, from their investment universe when they should be working with them to adopt cleaner alternatives to coal-fired power.

Working with development banks could be a way to improve governance in the emerging world. "They have more experience on the ground," Lindmeier says. "There could be more information sharing that allows investors, such as ourselves, who are worried about risk, governance and policy risk around renewables.

"Having local partners could give us more comfort about investing in those countries," she adds.

Common ground

Emerging markets is not an easy asset class for sustainable investors to hunt for value, growth or income. But it is needed in a world where the economic picture is deteriorating by the day and growth at fair value is becoming scarce.

Indeed, it turns out that the Oxfordshire Pension Fund may not have completely ditched its developing world exposures after all. It has recycled part of the proceeds from the sale of its emerging market portfolio into a passive Paris-aligned benchmark portfolio.

However, most of the funds will be directed through a sustainable equities fund managed by its pool, Brunel Pension Partnership. This could see some of its funds invested in emerging market assets "with all investments selected to deliver long-term sustainable investment performance", Oxfordshire's spokesman said.

This is an example of how important the developing world is with its abundance of natural resources and growing, younger workforce. But it is also a major contributor to climate change and needs capital to reduce its impact.

"In my mind, there is no global success in ESG without emerging market involvement," Sambor says. "Emerging markets will be a key driver of ESG improvement globally."

Developed world investors and emerging market assets will have to continue to be uneasy bedfellows. Our retirements and even our lives could depend on it.

Emerging markets will be a key driver of ESG improvement globally.

Jean Charles Sambor, BNP Paribas Asset Management

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DRIVING CHANGE IN CHALLENGING TIMES

ESG Club Conference 2023

These are challenging times for investors. They are facing uncertainty surrounding inflation, geopolitics and economic growth, but still have to earn their desired financial return while making the world more sustainable and equal.

portfolio institutional's second annual ESG Club Conference sought to tackle these issues through bringing experts together to discuss themes such as biodiversity and the energy transition.

The first part of our ESG Club Conference review starts over the page.
Our coverage concludes in our December-January edition, where we will look at the discussions on ESG data and social investing.

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ESG CLUB CONFERENCE: TRANSITION ASSETS – A PATHWAY TO NET ZERO

Fossil fuels power our homes and businesses, enable us to travel the world and build products that improve our lives. But time has proved that they are also a threat to life on Earth. Breaking our reliance on them means finding reliable alternatives, and not just wind farms and solar parks. The panel in this year's ESG Club Conference started with a look at how institutional investors can reduce our reliance on oil and gas.

This year's conference opened with BlackRock's Ewa Jackson describing the transition to a low carbon economy as "a mega force that is shaping the global economy".

And there are three drivers that she believes are influencing the shape, speed and size of how the transition will unfold.

The first is policy stimulus in Europe and the US. Then there are the technological advances we are seeing across a variety of renewables. Finally, there is consumer sentiment.

To help implement net zero into its products, BlackRock has developed scenarios of how they believe the transition will unfold. These scenarios start with the endpoint – say, a 1.5-degree temperature rise in 2050 – and then work backwards from sector and energy perspectives to see how we can achieve it.

Predicting the future is not easy, so BlackRock has defined tipping points within technological advances. For example, what are the "tipping points" that will make electric vehicles mainstream? One is if the car is cheaper than the fossil fuel-powered equivalent, while there is alleviating range anxiety in the consumer.

In this transition scenario, sectors and regions BlackRock believes are in the "fast lane" to decarbonise include property, energy and light transport, predominantly in developed markets. It also identifies heavy transport and predominantly emerging market assets as being in the slow lane.

"We are starting to use this scenario in our product development," Ewa Jackson said.

Powering up

Picking up the theme that cleantech is not limited to wind and solar, Newton Investment Management's Therese Niklasson said that cleantech can be found in the transport, infrastructure and manufacturing industries. "If we just take the energy transition, whether it's meat replacements or electrification, there are lots of areas to look at," she said. But it is not just about cleantech exposure, investment teams are looking at how the companies in their portfolios are being powered.

This is an approach adopted by pension pool London CIV, Jacqueline Jackson said. "We have funds that wouldn't be described as sustainable but give us an opportunity to engage with organisations to support the transition."

Almost a quarter of London CIV's infrastructure investments are renewables, which will play a part in helping the pool achieve its ambitious 2040 net-zero target. "Looking to the future, we will be focusing on not only how we fund decarbonisation, but how we invest in clean energy," Jacqueline Jackson said, adding that reforestation and carbon capture technology could potentially play a role in the pool achieving carbon neutrality.

WELCOME
DRIVING CHANGE IN
CHALLENGING TIMES

BNP Paribas Asset Management understands how influential it and organisations such as London CIV are in creating a regenerative economy. “We have long believed that asset owners and asset managers have a key role to play in financing the energy transition and helping to achieve net zero,” Thibaud Clisson said.

BNP Paribas AM is committed to slashing its carbon footprint by 30% in 2025, from 2019’s levels, and increasing this to 50% five years later.

It also has a framework that classifies companies depending on how credible they believe their decarbonisation strategy is. “Our goal is to have 60% of our assets under management in companies which are either achieving net zero or will be aligned by 2030,” Clisson said.

Going forward, the intention is to invest in more climate solutions. But while stewardship will be crucial in shaping corporate climate strategies, the asset manager will also work with policymakers to ensure that regulation is going in the right direction.

Gold standard

It is clear that the energy transition offers several opportunities to institutional investors, but they are more bullish in some areas than others.

Eva Jackson says that investors are particularly excited by real assets such as infrastructure and real estate. A lot of capex is required to unlock and scale some of these technologies and much of that will be upfront financing and through different structures. More broadly, in infrastructure, this means hydrogen pipelines into the grid and investment in transport.

And with regard to real estate, by 2030 all commercial buildings will need energy performance certificates graded A or B. Ewa Jackson believes that around 85% of buildings will need to address their rating in order to get to that standard. “So a huge amount of capex is required in real estate,” she said.

“From a thematic perspective, climate resilience is a theme which emerged strongly from the transition scenario,” Ewa Jackson added. “By 2050, we estimate there to be around a 5% impact to global GDP due to climate damage. So once again, requiring significant investment to address that.”

However, Newton’s Therese Niklasson pointed out how difficult it is to achieve consensus on where capital is most needed in the transition. “If four economists were sitting on this panel, they would probably not agree on where it’s most needed.”

She added that a lot of capital needs to be deployed globally, but in the UK there are 13 million buildings that need to be reworked for installation and heating purposes. “EV needs to have an infrastructure around it to make it work.

“The elephant in the room, however, is emerging markets,” she added. “Yes, we need investments in Europe and the UK, but we won’t achieve the energy transition if we leave emerging markets behind,” Niklasson said. “That’s where most of our emissions will come from in the future.”

Thibaud Clisson sounded an even louder note of caution. “It is fair to say that we are not necessarily on the right path,” he said. “We are consuming fossil fuels like never before. The effects of climate change are more and more visible.”

He added that the industry needs to act where it has the power to. This means bringing greener practices into private markets and engagement with policymakers to force through more regulation.

“We also need to address topics which are linked to climate change, but not necessarily perceived as being so. I’m referring to natural capital.

“Industry treats climate change and biodiversity as a silo, but we should try to treat it collectively,” Clisson said, pointing to BNP Paribas AM buying a Dutch sustainable forest and agriculture company.

“It’s a great opportunity to help our clients contribute to ecosystem restoration but also a natural carbon storage. This is how we can address the issue and make a difference.”

Keeping your enemies close

So, does this mean that to solve the problem, investors should embrace problem industries?

“Investing in oil and gas on the path to net zero is a complex and potentially contentious issue, but there is an opportunity for that sector to have a real impact through targeted engagements,” Jacqueline Jackson says.

London CIV has voted against Shell and BP for winding back on their transition targets and supported shareholder resolutions which requested financial institutions to stop funding new oil and gas exploration.

“But not all oil and gas companies are necessarily created equal,” she said. London CIV looks for extractive companies which have strong transition ambitions with robust decarbonisation strategies.

“We cannot consume our way out of a crisis by simply decoupling emissions against revenues,” she added. “What we look for is are our oil and gas companies reinvesting into greener technologies.”

Jacqueline Jackson described carbon offsets as a “red herring”, but pointed out that there are genuine opportunities to look at credible and robust carbon offsets and invest in industries that potentially offset portfolio emissions.

Short-term thinking, long-term gains

But what asset managers want you to do around climate risk is not uniform, Niklasson said. “There are many clients who might want you to focus more short term and are not willing to give up performance,” she added.

Ewa Jackson
Head of sustainable client solutions, EMEA, and a member of the sustainable and transition solutions team
BlackRock

Therese Niklasson
Global head of sustainable investment
Newton Investment Management

Jacqueline Jackson
Head of responsible investment
London CIV

Thibaud Clisson
Climate change lead
BNP Paribas Asset Management

This varies across the world, with the US and Europe taking divergent routes. "This is important to asset managers, because we are not investing our own capital. So that is a big challenge we are working on," Niklasson said.

Then there are the conversations with portfolio managers. "You won't get the attention from the investment team if you keep talking about 2050," she added. "We have to make this a much more short-term conversation, looking at the timeframe through which they are investing. So we need to roll back the dialogue to make it more relevant for the investment teams to be incentivized to get involved."

The other issue is policy and regulation. "It hasn't gone far enough or fast enough for there to be a level playing field," Niklasson said. "Public markets are not going to solve this on its own. That is a little bit the frustration at times that it is almost like everyone's looking to us as investors to solve all of this, and for the markets to do its bit to solve the energy transition and climate issues. And it is not going to happen on its own. We need much more clear, uniform policy and regulation developments."

Going underground

However, we appear to be in something of a Catch-22 situation. Building wind turbines, solar panels and electric batteries requires minerals, we need more houses, which have to be extracted from the ground beneath us, which is far from kind to our planet.

"We are talking about quite traditional industries that potentially have quite antiquated technologies," Jacqueline Jackson said.

But there are emerging opportunities in these sectors, including using scrap materials in steel production, or fly ash in the production of concrete. "One thing that is often overlooked is the siloing of these technological advancements in these types of sectors," Jacqueline Jackson said. "When you look at some of the opportunities that are emerging, they are interlinked."

So mining and technology companies need to come together to understand where there can be cross-sector efficiencies, such as using waste from one production process in another. "That is often an area that gets overlooked because with competition and innovation needed, it can be quite difficult," Jacqueline Jackson said.

ESG CLUB CONFERENCE:
BIODIVERSITY – PARADISE LOST?

Biodiversity supports life on Earth. It feeds us, purifies our air, provides us with medicines, fights climate change and could protect us from natural disasters such as flooding. Yet pollution, construction and overfishing are not only putting half of the world's GDP at risk but our lives, too. The second panel at the ESG Club Conference 2023 sought to discover what institutional investors are doing to stop the destruction of our ecosystem.

The WWF's Josephine Quint opened the conference's biodiversity panel with a few sobering thoughts: "Nature is in a pretty awful state," she said. "We estimate that we have lost 69% of our natural world since 1970."

The figure jumps to as high as 94% in some regions, such as Latin America. Yet the situation in the UK is not much better with it sitting among the world's most nature-depleted countries.

This is important for the financial institutions and corporates working to keep average temperatures low. "We have to be clear: we can't achieve net zero without nature," Quint said. "Nature loss and climate crises are two sides of the same coin.

"If we look at greenhouse gas emissions globally, 23% come from deforestation and land use change," she added. "If we are to achieve net zero by 2050, 37% of the emission reductions needed will come from nature, so this is important."

The natural world underpins our economy with 55% of global GDP either highly or moderately dependent on nature, PwC has found. This, Quint pointed out, has an impact on companies in all sectors, which to some degree are dependent on nature. "If there is no nature, there is no supply chain," she added.

Nature loss is, therefore, a financial risk. But it is also an opportunity. The UN estimates that $11trn (£9trn) needs to be invested in nature for the world to achieve its biodiversity goals by 2050.

How to identify and reduce nature risk in portfolios was a theme picked up by Lee Backhouse, senior responsible investment manager at Scottish Widows, who described the task as "difficult". "We are all looking at it with a fair degree of trepidation."

But he added that the first step is to reflect on what nature is and to understand the "wacky and wonderful characteristics of it". Then investors can spot any pressure points in their portfolio and how the impact arising from them could interact with their risk/return profile.

Not perfect

There is data available to help assess nature risk, but investors have to decide what methodologies to use and how they fit in with their aims. "It's not an easy task," Backhouse said.

This is due to there not being a single methodology to identify and reduce nature risk that suits everybody. "There is no one-glove-fits-all [approach]. There isn't a silver bullet," Backhouse said.

"But the data is there," he added. "It might not be packaged up in the way in which we as an industry like data to be packaged, it might not be in the bottles we like, but it is there and it can be used."

Yet there are issues over the quality of the data available, as there can be gaps. Backhouse, therefore, warned investors to manage

their expectations. “I would encourage anybody looking at nature right now to not get dragged into the perception for a need for absolute perfection before you start looking at this.”

What could improve the quality of assessments in this area are any potential crossovers with addressing climate change. For example, the reporting infrastructure for the Task Force on Climate-related Financial Disclosures (TCFD) could serve as a base to assess and manage biodiversity risk.

The same could be true if you monitor deforestation, given the negative impact land use change has on biodiversity. “There are lessons that can be learned from previous work, so you are not going into this from a completely new foundation,” Backhouse said.

For Mette Charles, Aon’s ESG research lead and associate partner, the key challenges trustees and investors face when thinking about biodiversity are time and expertise.

“This is another elephant in the room because trustees are already pushed,” she said. “Agendas are crowded. They already have to take on the huge subject of climate change and transition planning. Then there is stewardship and their implementation statements. They have a lot on their plate.

“Now biodiversity comes along. It is highly complex; the issues are difficult to understand and it’s difficult to know where to start.

“So time and more expertise is needed,” Charles added. “Trustees need frameworks and guidance, which are still being built and defined. It is going to take time and the challenges are enormous.”

Mapping it out

There are many aspects to nature risk and its impacts are locally specific, so where to start managing such risks?

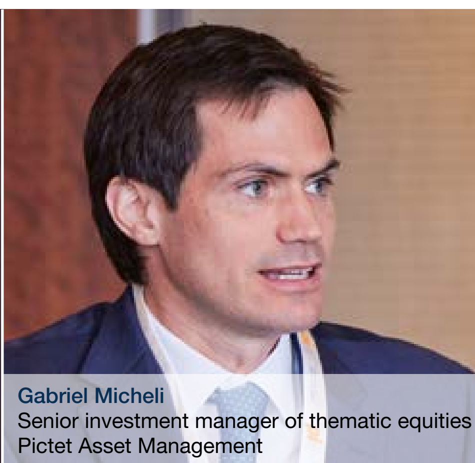
Lucian Peppelenbos, Robeco’s climate and biodiversity strategist, said that the first step is to make a heat map of your sector exposures. “The good news is that the science data is pretty solid,” he said.

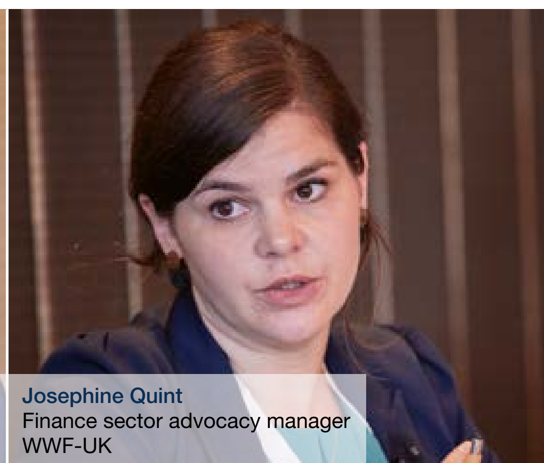
Replicating official research, for example, could help find your sector hotspots – the areas where you have the most nature-related risks. “You will find, just like with carbon footprints, that most of the impacts and risks are concentrated in a few sectors,” Peppelenbos said, explaining that consumer staples, materials and financials carry 75% of the nature risk in some of Robeco’s portfolios.

“It gives you focus,” he added. “You can zoom into those three sectors and reach out to your portfolio managers and ask: how are we addressing those risks in these sectors? Can you show it in your investment analysis and in your valuations?

“Then it is a matter of pulling up your sleeves and working your way through it,” Peppelenbos said.

Claudia Gray
Head of financial sector research
ShareAction


Gabriel Micheli
Senior investment manager of thematic equities
Pictet Asset Management


Josephine Quint
Finance sector advocacy manager
WWF-UK

Packing it up

Pictet has tackled nature-related risk in their environmental funds for some time, while its ReGeneration strategy, which was launched in February, specifically engages on the issue.

Examples of the impact Pictet is having in this area include at packaging companies. They work mostly with paper, which is recyclable, but sometimes a layer of aluminium is used. "90% of biodiversity loss comes from resource extraction and the use of those resources," said Gabriel Micheli, Pictet's senior investment manager of thematic equities.

"The more you can reduce that, the more you get towards a circular economy, the less impact you will have on biodiversity," he added.

Pictet works with companies to encourage the use of mono materials, such as if they use plastic, for example, it is only one kind of plastic which can be re-used.

Another company in its portfolio now uses forest-positive packaging meaning that they are replanting trees in biodiversity hotspots like Mexico.

Micheli said that more companies and investors are becoming aware of their biodiversity risks. "We have seen the re-rating of companies strongly over the past decade [due to climate change]. The same is going to happen with biodiversity, as companies understand their risk."

He added that investors are becoming aware of this given that consumer preferences are changing, while regulation is moving in the right direction.

Case by case

This comes back to the same issue: if investors are becoming more aware of the need to manage their nature-related risks, how should they do it?

When Aon interviews investment managers, how they approach biodiversity is an important part of that conversation. "It is interesting, because all of them come back to specific materiality on a case-by-case basis," Charles said.

And that is one of the problems with biodiversity. "There are no systematic, applied processes to demonstrate," She added.

There are, however, online tools that score the materiality of ecosystem services. Aon used the MSCI World to discover which ecosystem service was the most impactful or risky. The answer was water security.

"So that is a thematic way to start, but then you need to drill down in terms of locality," Charles said. "This is just the beginning of a journey.

"There is no silver bullet like with carbon emissions," she added. "It is early days, but there is data and there are starting points to get on with."

The right framework

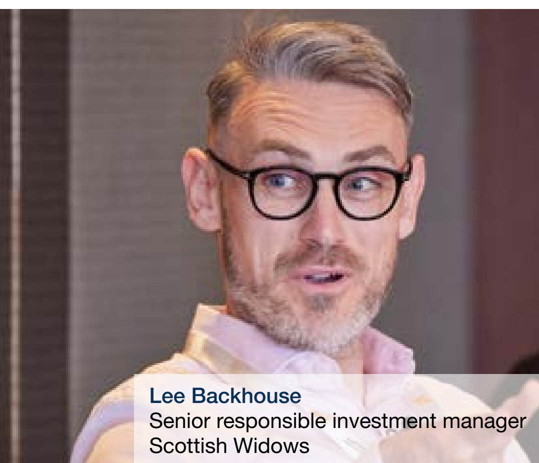
Understanding the complexity of nature is crucial in managing its risks. "Nature is multi-dimensional," Backhouse said. "There are many interconnections, it is just far too complex for one metric to even get anywhere near giving you an indication of what is happening.

"If you were to attempt to use a single metric, then you are pretty much abandoning that complexity and wonder of nature. And you are going to get little information from it," he added.

It could take a basket of metrics to understand any particular impact across a portfolio, but along with that comes a suite of methodologies, because different methodologies rely on different metrics.

In response to that, Scottish Widows work closely with the Zoological Society of London in order to bring in a level of understanding that can support their use of metrics and methodologies.

Backhouse also likes the EU's Biodiversity and Business Platform, a biodiversity measurement navigation wheel that enables investors to identify which metrics, which approaches and which methodologies are going to suit their specific needs. "That wheel is essentially a performance decision framework,"


Lee Backhouse
Senior responsible investment manager
Scottish Widows

Lucian Peppelenbos
Climate and biodiversity strategist
Robeco

Mette Charles
ESG research lead, associate partner
Aon

he added. "And by systematically working through the criteria that make up that framework, that enables you to home in on what you need."

Frameworks will be increasingly important in managing nature-related risks. Indeed, Pictet launched a strategy 10 years ago using the framework of the planetary boundaries as a starting point. One of the framework's nine environmental dimensions is biodiversity.

Looking at how much value a company has created, relative to the resources it uses shows how efficient a company is. "Biodiversity is usually the combination of land use, climate change, water use and pollution. But if you look at how much value a company is creating relative to what it uses, you see a clear impact on financial performance over time," Micheli said.

For Peppelenbos, the Taskforce on Nature-related Financial Disclosures (TNFD) framework will be highly useful. "It is, of course, building on six years of experience of TCFD, replicating its structure.

"Now the key challenge is going to be: will it generate data that is investment relevant, that is comparable and that we can aggregate in portfolios? Indeed, there is no single metric, it's case by case. That's the big challenge.

"Sector is the key here. We need sector by sector guidance on what are the key impacts, the key underlying drivers of biodiversity loss and the key mitigating actions in a sector to mitigate those drivers.

"For nature, we need the same pathways as we have for climate change," he added. "We have sector decarbonisation pathways, it gives the timelines, the thresholds and the technologies that need to come into place. We need that for nature as well."

Food for thought

Another issue that is damaging our ecosystem is how we put food on our table. Quint said that our food system is extremely damaging for the natural environment.

"It is the biggest cause of deforestation," she added. "It is the biggest driver of freshwater stress. It is the biggest cause of destruction of wildlife and aquatic life in oceans and rivers."

Quint called for a rethink on how we tackle the "triple challenge" of feeding a growing population while maintaining average global temperatures below 1.5-degrees and reversing nature loss. "In order to achieve that transformation, we will need all stakeholders within the food value chain to work together," Quint said, adding that such co-operation will have to push for much less use of artificial fertilizer, reducing food waste and better management of livestock.

Good COP, bad COP

The conversation then turned from investors to politicians, especially concerning the COP15 meeting in Canada last December, where Peppelenbos was philosophical. "COP15 is nice, but what really drives politics here is the law of physics. We are in the Anthropocene, a new geological period after billions of years where the human footprint is now shaping the Earth's system.

"Nature's cracking and it's knocking on the doors of politicians, but they don't really like it because nature doesn't vote. It doesn't win elections," he added.

So politicians reluctantly take it on board through COP15 and other frameworks, which have their benefits. "COP15 doesn't have any legal status, but it creates a peer pressure process," Peppelenbos said. "Diplomats are forced together in a room where they pursue each other and review their plans.

"That will help to accelerate this inevitable policy response, but it is not going to be a piece of paper that does all of this. It's the laws of physics," he added.

But COP15 did produce a biodiversity agreement among most of the world's governments. Indeed, 188 countries agreed to protect a third of our planet for nature by 2030, which will see more support for the world's rainforests and wetlands. "A deal is only as good as its implementation," Quint said. "We need ambitious national plans that will show how countries will deliver against the goals and targets set in this framework."

AFFORDABLE HOUSING: LAYING THE FOUNDATIONS

With inequality in Britian widening and the need for cheaper housing increasing, could institutional capital save the day? *Andrew Holt* reports.

Like a famous line once said in 1980s film, build it and they will come is an approach many institutional investors are taking to affordable housing, a much-needed new chapter in the property sector. Thankfully, investors have turned up at the right time.

"The demand dynamics in affordable housing are, in one sense, terrifying," says Chris Jeffs, a manager of M&G's Shared Ownership fund. This parlous position is in reference to homeless charity Shelter's estimate that 1.2 million people are waiting for affordable housing.

Hence the need for investors to boost the affordable housing sector through providing much needed private capital. "There is a dearth of quality of affordable housing," Jeffs says.

"This is a nationwide issue," he adds. "And the disparity between the delivery of affordable housing versus demand continues to grow."

England alone will need 600,000 homes each year based on current immigration levels, according to the Centre for Policy Studies, a think tank, which highlights the size of the task.

"This is wider than just institutional investment," says Ben Denton, chief executive of affordable homes at Legal & General Investment Management (LGIM).

True cost

The think tank's estimate highlights the uphill struggle facing the affordable housing market, given that supply is nowhere near keeping up with the pace of demand.

"The principal reason for this is the majority of affordable housing is still delivered by housing associations and charities," Jeffs says. "And housing associations probably have more constraints than they ever had."

One of the biggest burdens housing associations face is cost. Important issues such as fire safety and the green agenda, means making buildings fit for purpose is a significant cost.

Then there are maintenance costs, which have jumped by a whopping £1.5bn in just four years.

Supporting this picture, a report by real estate lender and investor Octopus Real Estate revealed that increased construction and finance costs have led to a third of housing associations to report a deficit of between 11% to 25% on individual developments.

Worryingly, housing associations anticipate a 22% reduction in the number of new affordable homes being built. The affordable housing sector appears to be going backwards when it is most needed.

Closed market

Another factor is that debt has been particularly popular in the past decade as housing providers sought to make the most of a low interest-rate environment.

However, interest rates have soared, especially since the mini-Budget in September 2022, resulting in fewer housing associations and other providers being active in the debt markets. In many cases, providers are avoiding raising debt altogether until rates return to a more favourable level.

According to Octopus Real Estate, during the past decade the sector has built affordable homes through using its surplus to service what was previously low, fixed-rate debt. Not only are surpluses being squeezed, but they do not go as far as the price of debt has risen.

This is making interest payments higher, ultimately reducing the amount of debt that providers can – and, prudently, want – to take on to build new affordable homes.

"Such constraints limit housing associations' development activities," Jeffs says. "So this is where private capital can make a huge impact."

Yet while the present affordable housing picture may be somewhat difficult, M&G remains enthusiastic. "It is a super attractive asset class," Jeffs says.

The demand dynamics in affordable housing are, in one sense, terrifying.

Chris Jeffs, M&G Real Estate

M&G is not alone in its bullishness. In a study, real estate services specialist Savills said there is £27bn in private capital targeting the affordable housing sector. "That will have a huge impact on delivery," Jeffs says.

It gets better. That private capital will not have the same legacy issues and constraints as housing associations do. "We can accelerate the new delivery of affordable housing," Jeffs says. "And through the right partners, there will be the delivery of better designed, more sustainable homes with good management services."

To show that it is putting its capital where its commitment is, M&G has struck a series of deals worth a combined £62.7m. It has bought 370 homes through a trio of partnerships with Chelmer Housing Partnership in Essex, Hyde Group in Harrow and Park Properties Housing Association, which is backed by property investor HSPG.

"The real benefit of those partnerships is the capacity for them to grow," Jeffs says. "All these partnerships have real flexibility."

Three choices

Looking at the affordable housing market as it is constructed in the UK, there are three regulated forms: shared ownership, affordable rent and social rent.

The key aim within these is for investors to assist with the multiple funding challenges faced by housing associations by bringing big bags of long-term capital into the sector.

Research by Savills highlights a real growing appetite from housing associations to partner with investors and for profit registered providers (FPRP), which now own more than 28,000 affordable homes – 35% more than they did in March 2022.

The growing presence in this market by FPRPs is only likely to accelerate as investor demand for affordable housing with long-term inflation-linked income shows no sign of abating. FPRPs are forecasting the addition of a further 9,300 homes by the end of 2023, taking their total stock to almost 37,500.

A sharing society

Indeed, with the closure of the government's help-to-buy scheme earlier this year, shared ownership offers an affordable route to home ownership for first-time buyers and those who are unable to afford owning their home outright.

The part-buy-part-rent model provides a secure home managed by a professional landlord through a reduced deposit based on an equity share, whilst the rent on the 'unbought' equity is often significantly lower than the equivalent market rent.

Shared owners then have the benefit of house price growth and the ability to increase equity share – otherwise known as 'staircasing' – at a manageable pace.

Although the government committed £11.5bn to deliver 180,000 affordable homes between 2021 and 2026, this number could jump if Labour wins the next election. Sir Keir Starmer has promised to build 1.5 million homes in his first term, but how that would break down with affordable homes is, as yet, unclear.

Recycling capital

Ed Clough, managing director of Octopus Real Estate, says that investment from FPRPs is important for the affordable housing sector to grow. "The sector and its investors have an opportunity to engage in a process to find more sustainable funding solutions that can bridge an era of lower grant funding levels and more expensive debt," he says. "Partnerships with FPRPs can support greater additionality at a time when traditional funding methods are not feasible in the sector."

In the case of M&G, it will directly fund the development of new homes or buy existing and pipeline stock, in turn, enabling housing associations to recycle capital into new developments and further affordable housing initiatives.

Looking at partnerships with housing associations and FPRPs, Jeffs believes that both approaches can benefit. "The housing association market has been around for decades. In it there is scale, experience and capacity. So partnering with these housing associations is attractive.

"The attractions of working with someone like HSPG is that it is super agile and super responsive, which is harder to find in the bigger housing associations," he adds.

Investments with benefits

There is within all this a growing trend for pension schemes to play their part and explore the investment opportunity in the

UK's affordable housing sector. This is evident within local government pension schemes (LGPS).

James Sparshott, head of local authorities at LGIM, says: "The creation of LGPS pools has led the opportunity for far greater investment, because of the benefits of scale. What we have seen is a diversification into a whole range of asset classes, and one of those has been affordable housing."

A typical example of this came earlier in the year when the London CIV UK Housing fund welcomed the Lambeth Pension Fund as its first local authority investor. The fund itself then committed to an affordable housing fund run by CBRE Investment Management, with the investment focusing on social and affordable housing, specialist housing and transitional supported housing. So the spiralling nature of pension capital is helping to shape the affordable housing sector.

Councillor Adrian Garden, chair of the pension committee at the London Borough of Lambeth, highlights this type of commitment is much desired among pension funds. "The Lambeth Pension Fund has for many years sought to invest in a fund that would increase the amount of social and affordable housing in the UK," he says.

Indeed, affordable housing can assist pension funds in a number of ways. There is fulfilling a strong ESG commitment: with institutional investors increasingly placing more emphasis on the ESG impact of the investments that build new homes for households in need generates positive, and real tangible social benefits while demonstrating a practical commitment to responsible investing. That ticks many boxes in one go.

Alex Greaves, head of UK and European living at M&G Real Estate, says there is a natural fit between pension funds and affordable housing. "Long-term money, with long-term horizons, should absolutely be investing in affordable housing," he says.

LGIM's James Sparshott agrees: "Affordable housing is aligned with pensions on so many levels."

Affordable housing is aligned with pensions on so many levels.

James Sparshott, LGIM

Dean Bowden, chief executive of London CIV, cites the market's attractions for investors. "Affordable housing offers attractive characteristics including income that typically tracks inflation, high occupancy and low void rates, and low correlation to other real estate sectors," he says.

Jeffs hones in on the inflation matching nature of affordable housing. "That is the difference between the private market and affordable market: affordable and social rents are linked to either the Consumer Prices Index (CPI) or Retail Prices Index, with the latter being shared ownership, so you get that explicit inflation hedge."

For Denton, affordable housing is great for investors for all these things at once. "Affordable housing has good characteristics: it is a good hedge against inflation, it has a good correlation to CPI and good societal outputs. It is a good component of a balanced portfolio," he says.

Cautious about capital

There has, it should be noted, been some caution on the side of some housing associations in partnering with private capital. "And rightly so," Greaves says. "That is why building these partnerships is critical, because they can understand we are in for the long term."

Expanding on this, the first deal Greaves was involved in took five years to get off the ground. "That is because everything needs to be aligned. After all, it is people's houses at stake." But he adds that from here, the only way is up. "We anticipate a huge amount of further investment," he says.

Denton says it is about targeting an area or community where there is most need, but the process does take time. "It is a gradual journey," he says on private capital coming into the affordable housing sector.

In addition, Denton notes that investors should back ESG-focused affordable housing projects. "From a sustainability perspective it is important that the homes that are built come up to certain standards," he says.

Investors should also heed a warning about having diversification within their affordable housing portfolio. Something on which Denton offers some advice. "It helps to have a diversified portfolio across the country and different types of homes in the marketplace. It helps to diversify risk," he says.

Clough though notes that private capital entering the affordable housing sector is the way forward. "We believe that equity partnerships represent the next wave of innovation in the sector, comparable to the 1980s when registered providers were given access to the debt capital markets," he says.

"While some may be sceptical about this new way of working, ultimately, we hope that registered providers can unite around our common goal: building affordable homes for the people who need them."

pi DIVERSITY HUB

Some believe that recruiting people from different backgrounds and cultures could help investment teams produce better results. This month's Diversity Hub looks at where investors could find the people needed to build inclusive teams.

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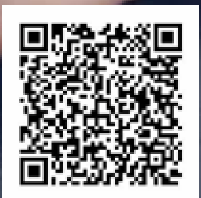

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DIVERSITY: MIXING IT UP

With the voices calling for greater diversity in the investment industry getting louder, *Andrew Holt* looks at the issues defining the debate.

Diversity has been a much-discussed issue in finance for some time. But for investors, there is a practical challenge: how can an effective diversity, equity and inclusion (DE&I) approach be incorporated into an investment strategy?

The big point in the whole debate is that this isn't a clear-cut issue. A clearly defined target like net zero with its precise future objectives, it is not. Inevitably, therefore, different investors have different ways of interpreting the issue.

This is something Omer Sanchez, chief investment officer of the endowment and foundations practice at Cambridge Associates, recognises. "Diversity means different things to different organisations," he says.

"We work with clients who have different definitions. One, for example, specifically focuses on black and Latino-owned investment firms. That doesn't mean we are not going to work with other diverse firms," he adds. "But in terms of the intentionality in that context, it is a bit more of a narrow definition."

Sanchez then notes the important focus within the debate itself. "I have worked with a lot of other foundational clients where they have a broader definition: focusing on women and people of colour. What is most important, is that its relevance and resonance for you as an organisation, and in terms of your mission," he adds.

A different view

Adding another interpretation, Newton Investment Management's Mitesh Sheth has an interesting take on the debate from an investor's perspective. "I don't sit here as chief investment officer of multi-asset strategies thinking that I must tick a diversity and inclusion box," he says.

Instead, Sheth looks broadly across the investment market, where numerous people are doing the same job and questions how he can get different perspectives – an intellectually diverse economy of scale. "For me, it starts with, where do I find untapped pools of talent. People who have different life stories, different risk appetites and see the world through a different lens," he says.

Sheth defines this in a different way, at least compared to the normal diversity narrative. "You don't start with how people look, or with their CV, you have to do personality and risk assessments: what is the different risk appetite of the people in your team?"

This, notes Sheth, can be done by taking a different approach to recruitment, such as finding people coming straight out of school who cannot afford to go to university. "I find that an interesting population," he says.

Also, he says, those who have worked in the industry and taken a career break, helping them back into the industry is another non-traditional route, which can be easily defined as diversity. "I have been able to bring in diverse talent who can see the world through that different lens and different life experiences," Sheth says.

Three Ps

Addressing the matter of having a commitment to invest with diverse firms, Sanchez says there is an important starting point. "I would say that if you are working with an adviser, or even if you are not, you want to be sure the diligence you are undertaking and the coverage you have of firms is inclusive and expansive. You are looking at the broadest set of investment opportunities that you can, including diverse firms."

Sanchez adds there is an important part to doing this. "The key element is making sure you are incorporating [diversity] into the investment policy, because that is the document that is going to guide the implementation." And from there, hopefully everything flows.

When it comes to investment firms defining the objectives necessary to build a more diverse portfolio, Sanchez offers some advice based on Cambridge Associates' 'three Ps' framework, which are purpose, priorities and principles.

"Purpose is about establishing the true norm of an organisation, what do you stand for, what is your mission and what are your values. And being clear about that. Priorities are about setting those thematic priorities, adding to that vision and values," Sanchez says.

"Then the principles are the parameters you are going to set in a policy context ultimately guiding implementation and have a common understanding of what success looks like," he adds. "So that would be things like defining diversity and looking at a particular metric to gauge progress. Hence the diversity objectives that have been set."

Outperforming

Connecting the issue back to an ESG grounding – from where many would say it has developed – Kazee Clement, senior executive director of The Network of Networks (TNON), which mentors corporates on diversity issues, says investors should begin by reviewing their portfolio companies for ESG risk, since companies rated higher on ESG outperform the market. It is a basic argument that leads many ways.

"The social aspects of a company's ESG profile include customer relations, a company's internal diversity and inclusion initiatives, response to societal trends, health and safety, and responsible production, which are all linked to DE&I," she says.

As part of this, Clement argues that investors should remain resolute in their commitment to ESG principles and "not be swayed" by the rise of the anti-ESG agenda, and with it, a commitment to DE&I. "While this issue is unlikely to disappear, it is crucial to encourage companies to continue advancing their DE&I agendas," she says.

Several organisations, including the Financial Conduct Authority and Nasdaq, have already established DE&I rules for public corporations, which can serve as valuable guidelines for investors, she suggests. "Investors should embrace ethnicity pay gap reporting as part of a comprehensive approach, in addition to achieving the Parker targets and fostering an inclusive board culture."

The right questions

From these clear narratives, there is, for Clement, a clear imperative on the investor community. "The investment community should demonstrate a strong commitment to raising DE&I topics with companies, as investors have the power to influence management and boards by engaging in meaningful dialogues," she says.

In this context, Clement says that management companies are increasingly engaging with shareholders, making it an attractive avenue for setting the context for conversations on DE&I. "This engagement can involve asking pertinent questions such as addressing efforts to reduce the ethnicity pay gap, assessing the return on investment in DE&I initiatives, examining the diversity characteristics of the executive pipeline and holding [senior] individuals accountable for DE&I progress," she says.

But there is an issue. Like all ESG-related data, diversity data is not perfect. Therefore, Clement suggests a course of action that other investors may question. "Investors must proactively identify companies" that excel in DE&I efforts and "those that lag" behind. "Investors need to push for more comprehensive and transparent data collection practices." She is not alone in calling for this.

Furthermore, Clement adds investors have real power in shaping the debate. "Shareholders have the opportunity to clearly outline their expectations regarding diversity at executive and board levels within companies," she says. "In the United States, shareholders have started requisitioning proposals related to US equity audits, and the 2023 season witnessed an unusually high number of shareholder proposals focused on racial justice issues."

Lost generation

Adding a complex layer to the debate, Sheth warns that some errors in the past may have meant that some of the best diverse talent has left the industry. "Our industry, over time, has pushed out various talented people that don't fit the mould. These are the real interesting pool of talent as a starting point," he says, in a rallying call to bring them back, in a big and wide ranging diversity drive.

This presents a potential lost generation of diversity-focused investment professionals, just because they did not fit the norm: they were the wrong type at the wrong time.

Sheth, therefore, says the traditional way of assessing the issue is, for him, not the best way to think about diversity. "To define a firm in terms of diversity and inclusion are helpful markers, you will get different perspective, but it is a relatively crude measure. It is a starting point, but it isn't the answer."

Instead, he says: "What I am looking for is risk diversity and perspective diversity. This is hard, because as humans we like being comfortable. And here, we have to embrace discomfort."

In this interpretation, a different perspective is crucial for keeping investors sharp and focused, Sheth says. "When it comes to investment decision making it is important to gather those different perspectives, creating an environment where that dissenting viewpoint, that unpopular view is heard, and feels comfortable being heard – that becomes important," he says.

Fitting together

This presents a different version of diversity. And for Sheth, the focus for investors should begin with the hiring of talent. "The real key is creating an environment where different generations, different perspectives, languages and cultures can work together. And that is no mean feat. And it is not a one off exercise. You have to keep that work up."

This means that Sheth tries not to have a single house view, potentially a huge diverse approach – at least in investment terms. "We have different investors with different investment philosophies co-existing," he says.

Sheth has also observed where diversity works within the investment process and where it doesn't. "Diversity works well within idea generation and the risk management space, which is: what am I missing? What could go wrong? What should I consider? What should I be worried about?

I don't sit here as chief investment officer of multi-asset strategies thinking that I must tick a diversity and inclusion box.

Mitesh Sheth, Newton Investment Management

"Where it doesn't work so well is in the decision making," he adds. "Ultimately you have to make decisions with imperfect data. Here you need a single decision maker, or two or three individuals, where efficiently you can make the decision happen."
For Sanchez, diversity can fit easily together under the investment umbrella. "We are working with our clients so they can add value and have a greater impact on the world. The way to do that is work with active managers that can add that value.
"We owe it to ourselves, and our clients, to cast as broader net as possible and find the best managers out there, including diverse managers. From our perspective, diverse managers are an extension of our search for value added. We are not lowering standards.
"We apply the same rigorous diligence, extremely rigorous to diverse firms as we do to non-diverse firms."

Some investors may perceive diverse managers as riskier investments, despite evidence to the contrary.

Kazee Clement, The Network of Networks

Big blocks

That said, there are big stumbling blocks. Clement says there are a number of obstacles that can prevent capital from flowing towards diverse managers in the investment industry. The first is a lack of representation.
"Historically, the investment industry has been dominated by individuals from certain demographic groups, particularly white males," she says. "This lack of diversity in the industry can make it difficult for diverse managers to access capital, as networks and relationships often play a significant role in fundraising."
The second is perceived risk. "Some investors may perceive diverse managers as riskier investments, despite evidence to the contrary," Clement says. Here she cites asset management firm GCM Grosvenor, which reported that diverse managers outperformed their equivalent benchmark in 83% of the periods measured, but diverse-owned firms represent just 1.4% of assets under management in the US.
Third is a capital allocation bias. "Investment committees within institutional investors may have biases that favour established, well-known firms managed by individuals from more traditional backgrounds," she says. "This bias can make it challenging for emerging diverse managers to secure capital commitments."
Fourth is what Clement calls industry norms and culture. "The investment industry can have a culture that is resistant to change and diversity which can perpetuate stereotypes and biases, making it challenging for diverse managers to break through."
This presents a narrative that poses numerous challenges within the diversity debate. The immediate response to this is: how can it change?
Clement offers a comprehensive checklist. "It's essential to promote DE&I in the investment industry actively, including on-going education and training about diversity and unconscious bias, expanding access to networks for diverse managers so they can access influential networks," she says.
Before adding: "Ensuring greater transparency and reporting on diversity-related metrics to hold investors and firms accountable and finally, increasing support for emerging and diverse managers to help them establish their track records and gain credibility."

Never-ending quest

When it comes to the stumbling blocks, Sanchez adds his interpretation on a negative interpretation of diversity in investment. "The misperception that there is some form of return trade-off dealing with diverse firms in that you have to lower your standards to invest in diverse firms versus non-diverse firms. That is the premise that you can reject outright," he says.
"If you look at the research, it tells you there is no statistical difference between diverse and non-diverse firms. So that doesn't hold water from our perspective," he adds.
Sheth gives an interesting take on how long this whole process will take. "In terms of when [diversity] will be achieved, I don't think ever, because it requires continuous work. It is like weeding your garden. You are never done."
And he adds another fascinating challenging perspective. "The danger is that the longer the different perspectives have been together, the more they end up coming together. They end up agreeing more and becoming more comfortable with each other. And it is then you have to add some challenges into that mix."
Based on that, the diversity challenge in investment is a never-ending cycle. Therefore, investors need to get ready for a long ride.

THE FINAL COUNTDOWN

£18trn

The additional investment needed to achieve net zero by 2030.

Source: Boston Consulting Group

£446.9bn

The collective surplus of defined benefit pension schemes at the end of September, up by £5.8bn from August thanks to rising gilt yields.

Source: The PPF 7800 Index

61%

...of energy investments by the end of 2023 will be in renewables, nuclear power, EVs and efficiency.

Source: Long-Term Infrastructure Investors Association/PwC

$13.8bn

The outflows from emerging market securities during September, $12bn of which were equities.

Source: The Institute of International Finance

27.5%

The year-on-year decline in private equity deal volume during the first nine months of 2023. Economic conditions have been blamed.

Source: Global Data

39%

The level of pension schemes intending to reduce their equity exposures in the next 12 to 24 months in favour of credit, LDI and annuities.

Source: Aon

€105.2bn

Inflows into European ETFs during the first nine months of 2023, taking assets under management to €1.43trn.

Source: LSEG Lipper

2.9%

The projected global growth in GDP during 2024, down from 3% this year and 3.5% in 2022.

Source: IMF

£41bn

The expected investment in UK commercial property this year. This is a third lower than in 2022 but is expected to improve by 15% to £47bn in 2024.

Source: BNP Paribas Real Estate

Quote of the Month

"There will be a greater focus on the natural costs of sustainability going forward."

Paul Brain, deputy CIO of multi-asset at Newton Investment Management

Pensions Management Institute

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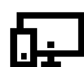
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1 IPE research as of 5/02/2023 based on total natural capital AUM (includes forestry/timberland and agriculture/farmland AUM). Firms provided AUM, where as of dates vary from 31/12/2021 to 31/12/2022.

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