PORTFOLIO INSTITUTIONAL DECEMBER–JANUARY 2024

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# 2024: PREDICTABLY UNPREDICTABLE

**GUY'S AND ST THOMAS'**
Making an impact

**PRIVATE MARKETS**
An alternative view

**ESG**
New thinking in a new era

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# 2024: PREDICTABLY UNPREDICTABLE

As we approach the end of the year, I have a feeling that something is missing. I had a similar experience this time last year.

Just like then, my inbox is not bursting with outlook notes from asset managers and investment banks as it once would have been in November. Indeed, I was still receiving analysts' economic predictions for 2023 in late January. And it looks like history could repeat itself as the uncertainty that lingered over the markets is still with us, although this time there is more to consider.

We still have relatively high inflation and war is raging in Ukraine, but now there is trouble in the Middle East, investors are pondering which way interest rates could go, while there could be changes in leadership in the US, the UK and the European Union in the year ahead.

But this hasn't stopped us from bringing you our annual look at what we feel investors need to know about 2024.

Our coverage looks at the events that could shape economies, equities, debt and private market assets. And then, of course, there is ESG.

These strategies are home to themes such as fighting climate change, halting biodiversity loss and reducing inequality, but it has been interesting to find out what the members of our ESG Club believe could be on asset owners' agendas in the year ahead.

This issue also features a review of our fixed income roundtable, where we looked at the strategies investors are following as yields rise and growth expectations fall.

Not only is this our outlook special, but it is our first issue of 2024 and so all of us at *portfolio institutional* would like to wish you a happy New Year.

We are looking forward to 2024 with particular excitement as we will not only host our third annual ESG Club Conference but we will also bring you a private markets conference in April while our awards return in the autumn after an eight-year hiatus.

It's going to be a big year!

**Mark Dunne**
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# CHANCELLOR GIVES INVESTORS SOME SUNSHINE IN AUTUMN STATEMENT

***Andrew Holt* looks at what the Autumn Statement means for institutional investors.**

Jeremy Hunt has achieved something of a rarity: his Autumn Statement was positively received by the markets and commentators. This was quite an achievement for this government, but what did it mean for institutional investors?

Private capital being used to improve the country's infrastructure is a narrative the government has promoted and so few were surprised that it was included in Hunt's speech. In a bid to boost the level of investment, he announced an overhaul of planning laws. This appealed to Ted Frith, chief operating officer at GLIL Infrastructure, a £3.6bn local government pension scheme-backed fund.

"The government's proposed changes will hopefully deliver more certainty and stability and give investors the confidence they need to support investment in the UK," Frith said.

But he highlighted that better planning laws are needed. "The lack of planning resources has been a source of frustration for infrastructure investment," he said. "Many developments have faced long delays, and some even lose their investors, depriving the country of the infrastructure upgrade the UK needs to supercharge economic growth."

### Going for growth

The much-touted government growth agenda was also touched on in Hunt's statement. The chancellor announced plans to consult on the details of how more defined benefit (DB) pension schemes could invest for growth. As part of this announcement, the treasury cut the 35% tax rate on extracted surplus funds to 25%.

LCP partner and former pensions minister Steve Webb said the announcement represents a "huge leap forward in plans to allow well-funded DB schemes to invest for growth".

"Provided that member benefits are protected, schemes would be able to build up surplus funds, benefiting existing members, the next generation of pension savers and the sponsoring employer."

Webb therefore noted that he looked "forward to seeing the consultation on the details" of how the new regime will work.

Nick Gibson, senior director at Cardano, added that the potential impact of the measures "could be significant".

"For corporate sponsors, the changes could increase opportunities to unlock value from their schemes, and allocate additional capital towards their corporate growth strategies," Gibson said.

"In that way, the government hopes that this will help to accelerate investment into UK productive finance, recognising that there are many potential uses of the additional capital raised."

### Added benefits

But Gibson noted the potential for added risk. "From a trustee perspective, it will be important that any additional flexibility introduced around accessing surplus does not increase the risk to the security of member benefits," he said.

To this end, Gibson welcomed the proposed review of new mechanisms to protect members. The proposals build on the chancellor's Mansion House speech during the summer where he put forward plans to encourage pension schemes to invest in a way that benefits UK businesses.

The chancellor also announced that local government pension scheme (LGPS) investment guidance will be revised to implement a 10% allocation ambition for investments in private equity, which is estimated to unlock around £30bn with the aim of increasing consolidation in to LGPS pools.

The chancellor also confirmed a March 2025 deadline for the accelerated consolidation of LGPS assets, setting a direction towards fewer pools and exceeding £50bn of assets.

### Rapid timeline

But this is a worry for Nigel Peaple, director of policy and advocacy at the PLSA.

"We are also concerned that the government is standing by its rapid timeline for the transfer of assets from pension funds to the asset pools in the LGPS, although it is potentially helpful that this will go forward on a comply or explain basis," he said.

An additional mention of plans surrounding the LGPS could be found in the accompanied statement documentation which revealed that pools should achieve at least £200bn in size, with a GAD calculation putting LGPS reaching £950bn by 2040, meaning that the eight pools would be reduced to four or five.

This brings some uncertainty for the LGPS going forward. Although this date is somewhat distant, and things could change quickly if, as expected, Labour wins the next election.

The government also announced plans to encourage the consolidation of small defined contribution (DC) funds, with a target for most members to be in a £30bn-plus scheme by 2030.

The Pension Protection Fund would be the consolidation vehicle for smaller schemes. It should be noted, however, that the smallest 2,000 schemes have less than £20bn of assets between them.

### Not a disaster

Focusing in on implications for the bond market, James Lynch, fixed income manager at Aegon Asset Management, said: "In the grand scheme of UK budgets, this was a mild disappointment, but not a disaster for the gilt market."

The market, he added, was expecting a debt issuance reduction this year of around the £10bn to £15bn area, but there have only been £500m of cuts, taking total gilt sales to £237.3bn.

# BONDS BOUNCE BACK

**After a torrid few years, there are reasons to be upbeat about bonds again, finds *Andrew Holt*.**

Bonds are back. That's the message of the latest portfolio institutional roundtable (see page 54). But is this valid? It is a question worth pondering, especially given that inflation is still relatively high.

Plus interest rates have stayed higher for longer. And although the threat of a recession has receded, it has far from being removed entirely.

This year has seen a small segment of stocks driving the market, the so called magnificent seven tech stocks – Apple, Amazon, Alphabet, Nvidia, Meta, Microsoft and Tesla – being the standout movers.

But it is worth noting that in bond investing there are many more issuers than in the equity market. And the high yields on offer should appeal to investors.

"If investors want to get two-year bonds and lock in these high yields for a shorter amount of time or extend out to 10- or 30-year bonds," said Natalie Trevithick, director and head of investment grade corporates at Payden & Rygel. "And even though their yields may be a little lower there than they are in the front end, given the inverted yield curve, you are locking in these higher yields for longer," she added.

## Longer maturities

Although a key point within this is when should investors start to lengthen maturities in anticipation that the rate picture is changing? "Now is the time to do it, because we have seen the curve start to un-invert," Trevithick added.

She noted that there is only about an 18 basis points differential between two-year and 10-year treasuries: just 18 basis points lower than that, and we have an upward sloping treasury curve from 10s to 30s.

"So, we are seeing more demand for 10- and 30-year corporate bonds because people want to lock in these higher yields for longer periods," Trevithick added.

Hal Cook, senior investment analyst at Hargreaves Lansdown, agreed, but sees a shorter timeframe as appealing. "On a five-year horizon, bonds are attractive," he said.

But on the flip side, Trevithick is seeing corporations wanting to issue more short-term debt: two, three and five-years because, even though they may be paying higher interest payments today, they do not want to lock in those rates for longer.

"So, there's a little bit of a bifurcation between what investors want to buy and what corporations want to issue into the market," she said.

## Regional attraction

Is there a regional basis for more attractive bonds? "We do see value globally on a name specific basis, but our preferred domicile right now is the US given our stronger outlook there," Trevithick added.

In addition, Philip Saunders, director at the Investment Institute, said for the first time since the 2008 financial crisis, bond valuations in the US and Europe are competitive relative to other asset classes – provided inflation rates remain moderate, which he expects.

"Developed market bonds offer a tactical opportunity which will not signal a return to the prior 'post-financial crisis' inflation and interest-rate regime," he added.

When it comes to emerging market debt, the policies of the developed world such as quantitative easing and zero rates were never an option. Consequently, their response to Covid was more fiscally conservative than developed economies.

They are benefiting from that now, Saunders said. "To generalise, the emerging markets debt story in 2023 is as follows: positive fundamentals, falling inflation and high real interest rates have resulted in relative resilience in the face of the duration bear market and a strong US dollar."

Therefore, new sources of industrial demand play into the hands of many emerging market countries, which are in a fundamentally better shape than in previous times of stress in developed markets.

Declining inflation will allow interest rates to fall in many emerging economies, providing opportunities in duration, Saunders added.

This dynamic would be boosted by an inflection in US interest rates, which would reduce the risk to emerging market currencies as they progress on their easing cycles. "We see Latin American economies, such as Brazil and Colombia, benefitting most, given their high real rates, positive inflation dynamics and solid external balances," Saunders said.

He also noted that he sees "interesting potential" in specialist segments such as senior and subordinated bank debt, as well as structured credit. "This is where we believe investors are overcompensated for credit risk compared to traditional high-yield and investment-grade corporate bonds," he said.

Despite the uncertainty of the macro-economic picture, Hal Cook said even if we do see a recessionary environment it will impact equities more substantially and negatively.

"A recession feels like it would be worse for equities as opposed to bonds, particularly if it makes central banks cut rates sooner than expected. At least with bonds you're being rewarded in with yield while you wait," he said.

The conclusion can only mean one thing: bonds are not just back but are a good investment opportunity.

*Read more on the market outlook from page 16.*

## PEOPLE MOVES

**Jill Mackenzie** is the new trustee chair of BT's pension scheme. She has replaced Otto Thoresen in the role after he stepped down in May.

Mackenzie spent six months on **BTPS'** trustee board shadowing Thoresen in preparation for her new role.

Also joining Mackenzie on the trustee board is **Andrew Clare**, a professor of asset management at Bayes Business School.

**Rachel Farrell** has been named as **Nest's** first director of public and private markets. She brings alternative investment experience across the US, Europe, the Middle East and Asia Pacific to the master trust after spending a decade at JP Morgan.

**Emma Matthews** has left **Now Pensions** less than two years after becoming head of investment. She has since joined Stockdale Asset Management.

Until a permanent replacement for Matthews is found, **Eleanor Levy** will be responsible for the master trust's investments while continuing in her role as chief commercial officer.

**Mike Weston** has joined professional pension scheme services firm **Pi Partnership** as an independent trustee.

Weston brings public sector investment experience to the firm given his time as the chief executive of Pensions Infrastructure Platform and LGPS Central.

**Clare Kember** has been appointed head of outsourced governance services at professional trustee specialist **Independent Governance Group**.

Kember, who has more than 20 years of pension scheme governance and trustee experience, joined the firm eight years ago and was promoted to trustee director in April 2022.

Finally, **Clare James** has been named head of sole trustee services at **Zedra**. The news highlights the growth in sole trusteeships across the pensions industry, the company said. James was a client director at Zedra for almost four years before accepting this role.

## CALENDAR

**Topics for upcoming *portfolio institutional* events:**

25 April
– Private markets conference

April
– Fixed income roundtable

May
– Defined contribution roundtable

June
– Emerging markets roundtable

03 July
– ESG Club Conference

July
– AI roundtable

September
– OCIO roundtable

24 October
– *portfolio institutional* Awards

November
– Natural capital roundtable

## NOTICEBOARD

Trustees of the pension fund sponsored by pharmacy chain **Boots** have transferred the scheme's £4.8bn of liabilities to **Legal & General**.

The buy-in covers the benefits of all 53,000 members and it has been reported that Boots will pay a £500m contributions on top of a £170m previously committed payment.

The **Co-operative Pension Scheme** has secured the benefits of its 50,000 members through a £4bn buy-in with **Rothesay**. The deal concludes the supermarket and funeral services provider's plan to fully de-risk the scheme.

The **Cornwall Pension Fund** is to build affordable homes in the county. The fund, in partnership with PGIM Real Estate, has bought a brownfield site in Camborne and provided funding to build 67 single-family rental houses. This project is part of a strategy to build affordable housing and renewable sources of energy in Cornwall.

**Access**, the £35bn pool for 11 local government pension schemes, has handed UK and global real estate mandates to **CBRE**. This is the pool's first private markets mandate.

It is expected that the UK mandate will be worth £1.25bn, while £550m will be available to build global exposure to bricks and mortar for the pool.

**The London Borough of Hammersmith and Fulham Pension Fund** has handed a buy-and-maintain credit mandate to **Allspring Global Investments** and **Insight Investment**. The £1.2bn scheme will allocate 15% of its assets to the strategy, with two-thirds being managed by Allspring.

The UK's first transfer to a defined benefit pension consolidator has been completed after the trustees of the **Sears Retail Pension Scheme** reached an agreement with **Clara Pensions**.

Sear's 9,600 members have transferred to the superfund, which will provide £30m to support the scheme on its journey to buyout.

The trustees of the **Air France (UK) Pension Scheme** have agreed a buy-in with **Just**, which protects the benefits of almost 200 members. The deal covers £32m of liabilities and is the scheme's third buy-in.

For the scheme's chair of trustees, Gary Barlow, this deal could be magic as it helps improve long-term member security.

**Just** also completed a £6m full buy-in with the trustees of the pension scheme sponsored by **Landor Cartons**. The deal covers 29 deferred members and 39 pensioners.

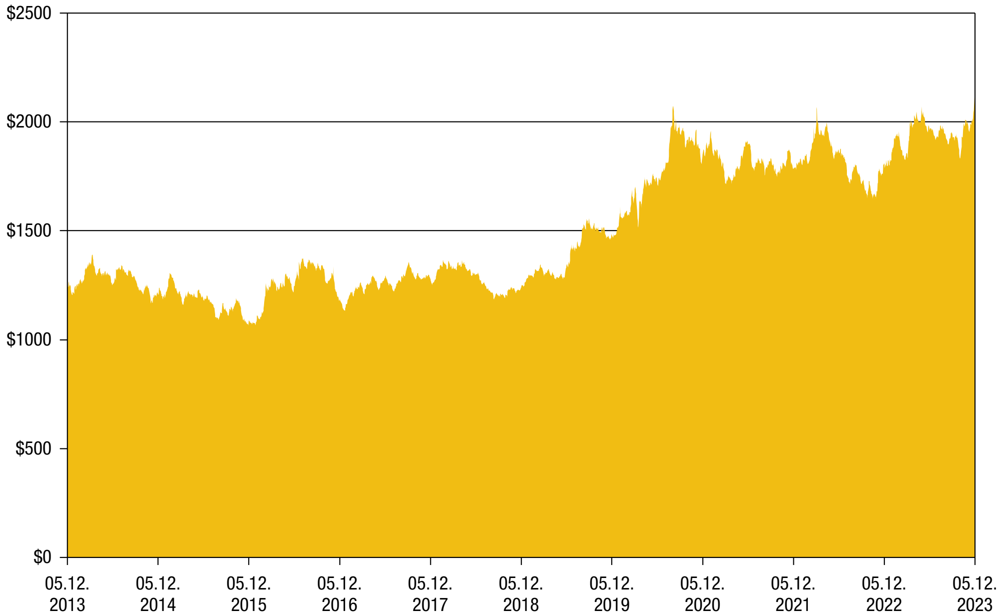
**Just** has also invested £350m in a social infrastructure portfolio. The insurer now owns more than 100 properties that provide childcare and specialist healthcare services. The investments offer long-dated, inflation-linked cashflows.

We end our round up with **Pension Insurance Corporation** investing £50m in building 125 affordable homes in London.

The mixture of debt and equity will build affordable and shared ownership homes in a former clinic in Kingston.

# THE BIG PICTURE: GOLD HITS HISTORIC HIGH

Gold prices: A 10-year view




Source: LSEG

**Record trading in the safe haven asset hides more issues than just a weak dollar, says *Mark Dunne*.**

As we prepare to welcome a new year, it appears that investors are not full of cheer. In early December, the price of gold reached a new peak, which is not typically a sign of confidence in the markets.

Indeed, on 4 December, the value of the precious metal jumped 2% to $2,111 (£1,673) per troy ounce – an historic high and the third time it has breached $2,000 in the past three years.

With so many issues shaping the markets, the price was unlikely to have been influenced by a single factor.

A weaker dollar, for example, on expectations that the Fed could cut rates next year, has made prices cheaper for those investing in other currencies.

Another factor could be that inflation, although falling, has been sticky for more than a year and currently stands at 4.6% in the UK and 3.2% in the US. There could be concerns among some investors that it may not fall to 2% anytime soon.

Then there is the ongoing war between Israel and Hamas and what it could mean for energy prices if other nations are drawn into the conflict.

Back in May, almost a quarter (24%) of central banks told The World Gold Council that they intend to increase their reserves in the coming year due to pessimism over the US dollar.

Then there are the stock markets. When it performs badly, investors will turn to gold to diversify their portfolios as the asset behaves differently to shares. Indeed, Goldman Sachs expect modest growth in US equities predicting that the S&P500 will only expand by 5% in 2024, while JP Morgan expects earnings growth in the US blue chip index of around 2% to 3%.

All of these factors point to a potentially difficult period for investors in 2024 and holding gold might help until the uncertainty lifts.

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

## HOW CAN DC LEVERAGE THE INVESTMENT KNOWLEDGE OF OTHER SCHEMES?

It's an exciting and challenging time for pension investment. There's nothing short of a whirlwind of developments, consultations and regulations coming into play. The Chancellor's Mansion House speech in July helpfully brought many of these together.

They include, among others, consultations (now closed) on how pension savers can best be supported at the point of access, a value for money framework, further rules around local government pension scheme (LGPS) investment and opportunities for more collective defined contribution (CDC) schemes to be developed.

Alongside this, the government is encouraging large defined contribution (DC) schemes to have at least 5% of their default funds allocated to private market equities by 2030. And let's not forget regulations compelling schemes to demonstrate that they are considering the potential financial impact of climate change and environmental, social and governance factors.

Unsurprisingly we are seeing significant development by government, pension schemes and their representatives. For example, the development of long-term asset funds (LTAFs), which are designed to work on DC investment platforms in order to enable smaller schemes to access illiquid assets. The National Employment Savings Trust (Nest) is leading the way for master trusts with 15% of its assets invested in illiquids in 2023, up from 10% in 2022; while the Productive Finance Group, which includes the PLSA, Association of British Insurers and the Investment Association, is working to help facilitate schemes to invest more into private markets, illiquid and alternative assets.

Despite these developments, regulatory intervention and innovation we have seen from government and industry, there is space for more collaboration between schemes of different types. The development of UK schemes is varied, from defined benefit (DB) schemes that have been with us since the 1600s, to the newer contract-based DC schemes and master trusts. Soon CDC schemes will be added to this landscape. UK schemes of different types may operate in different markets, face different challenges and even fall under different regulation.

However, that doesn't mean schemes can't learn from the experience of others, and, during these challenging times, it may be useful for newer schemes to look to larger or more established schemes rather than reinventing the wheel.

In particular, it could be useful for DB and DC schemes to take a look at how LGPS schemes have approached investment in illiquids and private markets.

In 2022, LGPS schemes allocated around £10bn to illiquids, up 24% from 2021 as they sought inflation-linked and high returns. Private equity and debt form a significant part of these investments, though infrastructure is the most popular asset class. These increases into alternative assets are motivated by a variety of factors, including government encouragement, the poor performance of listed assets and the advantages LGPS schemes gain from being invested in pooled funds. While the unique pooling approach of LGPS makes some read across difficult for individual DC schemes, there are potential lessons on how best to use consolidation, DC asset pooling and the assets of larger schemes.

It may be helpful for DC scheme providers to speak to individual LGPS schemes and pool providers, to understand how to identify and access illiquid and private market assets, particularly with a focus on how to overcome barriers, conduct due diligence and negotiate pricing structures with third-party asset managers. Private sector DB schemes also have a lot to offer, based on years of running pension schemes and responding to market and demographic changes.

While DC schemes clearly face different challenges around charging and a higher level of transfers in and out, there are still similarities between institutions whose main aim is to ensure that members and/or employees receive a decent income in retirement.

And as this is such a challenging time, with so much change afoot, it makes sense for schemes to leverage available knowledge as much as possible.

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## ABSOLUTE SECURITY IS ABSOLUTELY UNAFFORDABLE

If it was not for Brexit, UK trustees would, in common with their European counterparts, be working towards an imminent deadline for the production of an own-risk assessment.

We may still have to do this but there is no reason why we should not undertake this valuable task on our own initiative. Before highlighting some of the major risks we face, it is worth commenting on the binary approach to risk which is built into UK psychology. The discovery that some hospital roofs were passed their sell by date gave rise to the clarion call: "Shut the effected hospitals."

But hang on a minute – closing hospitals would result in casualties while undertaking a risk assessment which identifies mitigations that could help keep hospitals open and hopefully improve the overall outcome.

The biggest risk inherent in our increasingly defined contribution (DC) pensions landscape is that of under provision. There is no market solution for the needs of those who are on lifelong low earnings. A universal basic state pension does not only provide social cohesion but it also ensures that absolute poverty in old age can be avoided while forming a foundation upon which market solutions can be based.

Political risk is ever present. The timescales associated with pension arrangements do not fit neatly into the electoral cycle. What is more, politicians often fail to appreciate the implementation challenges associated with good ideas which are not quite so good if they fail the practicality test.

Politicians also fail to recognise that the main purpose of putting money aside in a pension scheme is to provide financial security in later life. Obviously, the money should be invested responsibly but member outcome should be our main concern.

I am a big fan of regulators, but not quite so keen on regulation. The best form of regulation is that which is risk based and proportionate. This requires bravery on the part of the regulator and a willingness on the part of the regulated entity to use their professional judgement when responding to a light-touch regulatory framework. We should not be asking the regulator to tell us what to do. If the regulator is too prescriptive, the moral high ground will be lost if things go wrong.

Employer disengagement is another risk. Consolidation should not be used as an excuse for employer abdication. There is a danger that auto-enrolment turns pension contributions into another tax. A good pension scheme can be at the heart of an attractive programme of employee benefits at a time when the recruitment and retention of quality workers is at the top of our agenda.

Members may confuse volatility and investment risk. Volatility can be our friend on a long journey. Those responsible for the investment strategy should leave no asset class out in the cold as we seek to provide a seamless DC journey from apprenticeship to care home residency.

The most worrying risk in DC land is administration. We have scored an own goal in seeking to provide a bespoke service for a commodity price. If we cannot get the admin right, society will lose confidence in everything that we do.

The penultimate risk is that of scheme governance. I am sufficiently old fashioned to believe that governance and delivery are important but separate. A diverse board should be responsible for monitoring the work of sub-contracted specialist. Diversity does not simply mean a mix of race, gender and age. If we are to avoid group think, social diversity needs to be encompassed.

The last risk is the risk register itself. These can become so detailed that they prevent a clear focus on what matters. The final agenda item on one of my trustee boards is "new risks" this provides an opportunity to see if the most recent meeting has highlighted any new areas for concern.

We need policies, risk registers and checklists but the only checklist which is worth the paper it is written on is where the final row reads: "now engage brain".

For example, picture an airline pilot who, having completed the pre-flight check, pauses for thought and walks around the plane before strapping in ready for take-off.

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# INTERVIEW – EMMA DAVIES

## "The world changes fast as people are always coming up with new ideas and you have to keep an open mind."

The chief investment officer at the Guy's & St Thomas' Foundation talks to *Andrew Holt* about the big agenda she is instigating to transform the organisation by bringing investments in line with its defined mission.

**How have your first six months in the role been?**

This is my dream role and it has been brilliant. I love being an investor. I love putting capital to work and being able to do that under a dual mandate, to produce financial returns and health impact, which is incredibly rare. To fund a mission-driven organisation and generate returns is something I love doing.

To fund charitable purposes is a dream come true for me. So in that sense, bringing the charity angle and the investor angle together is an ideal combination.

**What have been your biggest challenges so far?**

The institutions of Guy's and St Thomas' are close to 500 years old, but the Foundation in its current form has only been an independent entity for a few decades. On the investment side, we haven't had an internal team responsible for making investment decisions.

That is now changing. We are building and shifting that operating model, so naturally challenges come with that. One of the reasons for hiring an internal CIO is so we can take the decisions in house. If you want to align your investments with your values – which is the big motivator for us – that is something we have to do for ourselves.

Big challenges come with that. Bringing that investment segment in house, while having that consistency of approach, the

consistent alignment of ESG, diversity, equity and inclusion and climate responsibility while looking at every angle we can to do our best with our capital, is a real privilege, but also a challenge, although an enjoyable and rewarding one.

**Can you give me an insight into the portfolio of the foundation's £1bn endowment?**

Firstly, we have £600m in private equity, public equities and diversified hedge funds. It's not far from a traditional allocation, with a quarter in private equity and the rest made up of liquid assets.

This £600m has been wholly outsourced in an OCIO [Outsourced chief investment officer] model, so this is being reframed as part of the new operating model from the investment perspective and brought in house. We will continue to work with advisers, but we don't need to recreate the wheel.

Then we have £400m in property. In this part of the portfolio, we have a lot of development sites on land around Guy's Hospital and St Thomas' Hospital.

We also have significant exposure to property in Southeast London. This is super exciting, because of the development plans. The idea is to build a life science hub in London. Then to facilitate that space for the entirety of the organisations involved in that ecosystem, be it a chemist, startups, pharma companies, hospitals, all who are involved in innovation. So we will facilitate all of those organisations coming together.

And on the portfolio, it is to maintain the real value of the endowment in perpetuity.

> **Your life is a blank mosaic and every single role that you have allows some of those blank little tiles to be coloured.**

**What is your approach to ESG?**

We are committed to responsible investment. We are in the process of establishing our responsible investment mindset and we are working towards a well-articulated approach so that we know in clear investment terms, what it exactly means.

We are doing a lot of work. We have begun the process. We have to think about where we set ourselves targets.

We need to push ourselves on this, to be at the forefront of thinking about how to invest in the most responsible way. It is about being able to invest holistically, but for us, at the same time keeping your mission very much in sight. Our aim is to use our capital to solve problems and drive outcomes that are aligned with our mission and with our values where possible. So there is an added layer of consideration.

But we are going to look at every future investment in the context of its financial return, risk and liquidity profile but also the impact that the capital being put to work is going to have on broader society.

I would say we already invest thoughtfully and with purpose. Our whole portfolio approach is living by our mission, but we are now trying to bring all of our thinking together and consistently in line.

After all, our money is being put to work by people who are thoughtful about all of those mission drivers in our organisation: the key being societal health. We also have some targeted impact investments, which is currently a small allocation.

But I would also note there is so much jargon in this space, and I don't love that because everyone has their own interpretation of what responsible and sustainable investment and impact means.

> **Some of the issues around greenwashing are still a problem.**

**How can the government help your work as a foundation?**

It can be challenging for policymakers. I don't believe in big government but regulation is important. Some of the issues around greenwashing are still a problem. But the point is about the issues being real: net zero needs to mean net zero.

As an aside to that, there should be a greater insistence on real data. That can help all investors make better decisions. If you have insightful data about what a corporate does, how they do it and social inequality metrics throughout the supply chain, it is going to make the world a better place and easier for investors to make ESG-related decisions.

**Are you hoping for better if there is a change of government in 2024?**

For our opportunity set and investment return, which are global in nature, it is a much broader challenge and set of issues than just the UK.

**What is the biggest difference between you as a foundation and other institutional investors?**

I have already hit the nail on the head with the mission. That is a big difference.

There is also the time horizon. We have the gift of time and it is up to us to manage that. We manage our own timing, because what we have to do is deliver returns and cash to fund our ongoing activities.

**You have expressed your commitment to diversity, equity and inclusion. How should DE&I influence the work of institutional investors?**

I have been speaking to a lot of asset owners and a lot of asset managers and some of them seem a bit confused about how it can work for them from a diversity, equity and inclusion perspective. There are reasons to care about this.

One is because if you want to encourage investment decision-making that reflects the world we live in, and look at all of the opportunities, it is proven that if you have a more diverse set of decision-makers you get a more diverse set of investments.

Therefore, if capital is spread more widely across all its potential homes in the economy that is a real benefit. You then get diversified-tested return streams, which are generally a better set of return streams. If you have a diverse set of employees at a fund that reflects the world you can invest in the whole range of opportunities on offer. It is a better return generating opportunity set and also gets capital to the places that are important.

There are so many horrible statistics about women entrepreneurs being underfunded – and the same with people of colour. The reason is people in finance and investment direct capital towards the people who look and sound like them largely. So if you diversify the people working in investment, you diversify the investment itself.

We have therefore set ourselves to think about funds where there is diversity in the team and a commitment to DE&I, so that we can see that reflected in the decision-making.

**We will continue to work with advisers, but we don't need to recreate the wheel.**

**So you are making changes on this front?**

Absolutely. We think about DE&I, we think about climate and then we think about the culture of integrity we should work in, which pulls it all together. We then think about if there is an intentional impact or contribution to the UN Sustainable Development Goals in terms of where the capital is being put to work. And overall, is it helping to drive our health outcomes?

It comes down to the fact we are pulling everything together and being consistent and thoughtful in exactly the same process, exactly the same way with regard to every single investment. It matters.

So the reason for bringing everything in house is to make the whole approach like a stick of rock – the ESG, the DE&I, the climate, the values, the mission alignment are going to cut through everything we do. And that, as I say, hasn't been the case before now.

**What is the biggest lesson you have learnt in your career?**

My motto is: always learn and make your world bigger.

The world changes fast as people are always coming up with new ideas and you have to keep an open mind. There is always something to learn, there's always a different perspective.

## EMMA DAVIES' CV

**May 2023 – present**
Chief investment officer
Guy's & St Thomas' Foundation

**Jan 2021 – Apr 2023**
Co-CEO
Octopus Ventures

**April 2016 – Dec 2020**
Partner
Marylebone Partners

**May 2013 – Mar 2016**
Principal in public markets/
head of property
The Wellcome Trust

**Jul 2011 – Apr 2013**
Chief investment officer
Big Society Capital

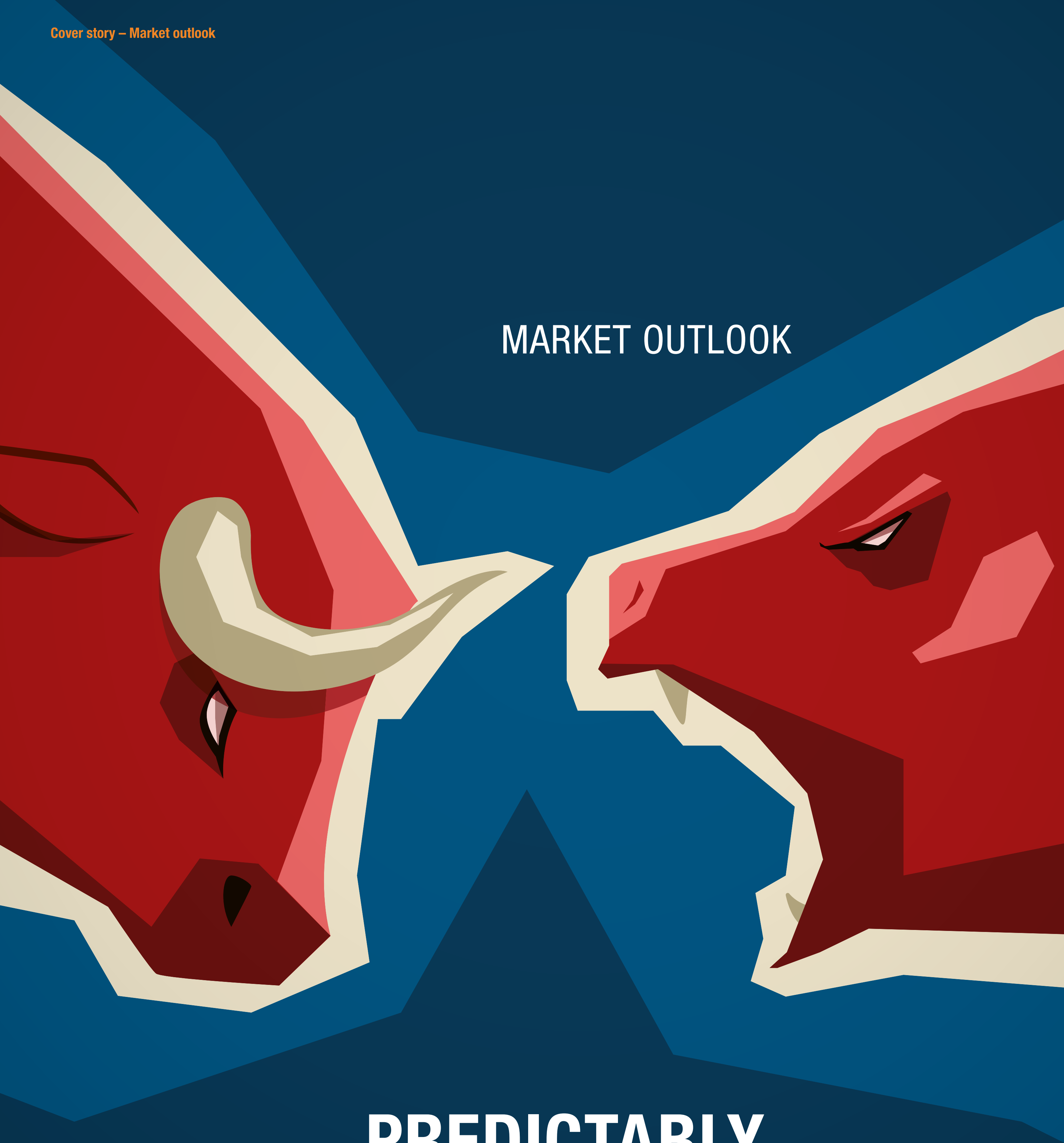
**You have worked in asset management and held roles in the charity sector. What were the biggest differences and which have you preferred?**

I have enjoyed every role. Your life is a blank mosaic and every single role that you have allows some of those blank little tiles to be coloured.

I would say I have the ability to be calm and make decisions for the long term, which is something I see as a gift. But also to be able to work in an organisation like Guy's that allows me to do that is a privilege. I have also worked with some brilliant people and learned an awful lot along the way.

**Do you see any challenges on the inflationary or geopolitical fronts?**

There are always challenges. The geopolitical situation is extremely sad from a human perspective, and you want to think the world can get to a better place. But from an investment perspective, the joy and the benefit of being able to invest for the long term and with that time horizon, these issues are more about the short term with more short-term implications. I have to keep my eye on the ball for the long term.



MARKET OUTLOOK

# PREDICTABLY UNPREDICTABLE

With much to ponder when assessing the outlook for equity and debt markets, *Andrew Holt* searches for the bulls and the bears.

The only predictable thing about the markets is their unpredictability. This, it appears, is not going to change in 2024. In fact, the many economic and geopolitical factors shaping the investment outlook could even intensify.

But given the many events potentially shaping the markets (see page 24), what trends can we spot emerging, particularly in equities and debt, during 2024?

Given the fractured nature of many markets it is inevitable that we are struggling to reach consensus on equities. Linda Bakhshian, deputy chief investment officer of equities and multi asset at Macquarie Asset Management, sums up the position.

"It is no surprise that as we look towards 2024, opinions about a bearish or bullish equity market outlook are divided," she says. "In our view, growth on the supply side of the global economy is likely to slow due to de-globalisation, increasing geopolitical tensions, shifting demographics, and more constrained monetary and fiscal policies," Bakhshian adds.

These could cause many headwinds. "Volatility and uncertainty are likely to be the hallmark of 2024 for equity investors, as we navigate challenges – including inflation and geopolitical tensions – and its impact on economic growth, company earnings and valuation of the global equity markets," Bakhshian says.

## Quality focus

For long-term investors, it would be prudent "to look through the short-term macro-economic debates and cyclical volatility", Bakhshian says.

This means positioning portfolios in "high-quality securities, with strong balance sheets, cashflows and management teams that are likely to weather through various market conditions, while positioning for future profitability and growth."

Further to this environment, surging yields and stealth stagnation may not be friendly conditions for broad equity exposures, says Wei Li, global chief investment strategist at the Blackrock Investment Institute. But this is not all bad news.

"Valuation dispersion within sectors has moved meaningfully higher relative to the past creating new opportunities," Li says. "Benefiting from this requires getting more granular, eyeing opportunities on horizons shorter than our six to 12-month tactical view and tilting to more active strategies that aim to deliver above-benchmark results," she adds.

Given the uncertain economic outlook and a preference for long-term quality, listed real assets remain attractive to Bakhshian, who is focused on listed infrastructure equities and real estate investment trusts, which stand out from a "valuation" perspective.

Selectivity and again, quality within each area is key, Bakhshian says. "However, both have come under market pressure and providing long-term investors opportunity for high relative yields and inflation protection," she adds. "Both areas also have high exposure to secular trends, such as the energy transition, digitisation and trade restrictions globally are driving on-shoring and re-shoring of manufacturing."

## Bulls and bears

There is always a bullish and bearish case to be made for equities, says Tapan Datta, partner in global asset allocation at Aon Retirement Solutions. "Investors have to ultimately take a view on which side of the argument they find more credible," he adds.

Exploring this further, the bullish case is that economic conditions will remain broadly stable in 2024, and that declining inflation will allow interest rates to fall back, removing the headwinds equities have been facing.

The bearish case is that the combination of much higher interest rates for a prolonged period, alongside likely recessionary economic conditions that dent corporate earnings will lead to another round of market falls in 2024, of the sort we saw in the first half of 2022.

Both are plausible. The consensus is there is no consensus. But Datta says: "Investors should also remember that there are more intermediate scenarios – the one we like sees equities challenged by economic and interest rate conditions, but not necessarily inducing a large bear market."

With that, which scenario appears more credible? "A bear market scenario would suggest that investors start to sell into market recoveries and look to have lower than target positions in their portfolios and vice versa for a bullish case which would suggest building overweights," Datta adds.

In his preferred scenario, he says: "A mild underweight to target or strategic positions would appear reasonable, but not a wholesale run to the hills for cover."

### Real rates

But the volatile macro-economic environment is always shifting the investment sands, even if it is sometimes only slightly. Fabiana Fedeli, chief investment officer of equities, multi asset and sustainability at M&G Investments, observes that given real rates are now in what can be deemed positive territory, even in the US, the equity risk premia have risen, putting pressure on equity markets.

"This could continue into 2024, and, while we still see pockets of future positive performance in equities, we are more cautious on the overall equity market in the near term," she says.

Fedeli also notes an important observation in terms of quality investments. "It's important to stay high on the quality scale, invest in companies with strong moats, pricing power, balance sheets and cashflow generation," she says. "We continue to favour structural long-term themes that should prevail, independent of near-term volatility, infrastructure, the low-carbon ecosystem and innovation, including AI."

As part of this, Fedeli says it isn't time to take a broad market investment approach. "As companies deal with a high interest rate and positive real rate environment, weak demand, and relentless innovation, there will continue to be winners and losers," she adds.

### Muted market

Wylie Tollette, chief investment officer at Franklin Templeton Investment Solutions, sees equity returns providing slightly "more muted return opportunities" over the next three-to-five years as the improved returns coming from fixed income now provide an attractive alternative for many investors.

That said, Tollette believes that opportunities can be found. "We find some of the more appealing opportunities in global emerging markets and in the US," he says.

Globally, he notes the picture "remains mixed" with European companies facing "greater threats from weak economic activity" and developed Asian economies impacted by weak Chinese growth. Focusing in on investor expectations, Michael Field, European equity market strategist at Morningstar Research, says: "Investors have a firm eye on 2024, optimistically hoping that stronger equity markets, combined with lower headline inflation, might mean better real returns."

Although he notes 2024 will be a tough year for business, with interest rates still at record levels and many firms struggling to service their debt. As such, it is likely that business insolvencies, which rose by almost a fifth in August, compared to the same month in 2022, will continue to increase in the new year.

> **It is no surprise that as we look towards 2024, opinions about a bearish or bullish equity market outlook are divided.**
>
> Linda Bakhshian, Macquarie Asset Management

"For investors, this means a focus on higher quality debt, where there is a higher chance of being repaid at the end of the term, would likely be a more prudent strategy than chasing debt instruments with the highest yield," Field says.

He makes the point that European equity market valuations are not cheap, currently seeing a single-digit upside to the Morningstar fair value estimate. "Given the weak economic backdrop, this is a time when even the most bullish of investors are not shouting from the rooftops about how attractive the market is," Field says.

But he also sees plenty of opportunities within European equities. "Sectors like utilities and pharma are now showing opportunities that did not exist six months ago," he says. "The opportunity in the former is driven by higher bond yields, and the latter driven by investors' lack of appreciation for the extent of innovation in the industry," Field says.

### Reasons to be cautious

Making sense of the market would be difficult without assessing the impact of global events. Luca Paolini, chief strategist at Pictet Asset Management, says the conflict in the Middle East threatens to further destabilise the global economy and financial markets. "A reason to be cautious – we remain neutral stocks and overweight bonds."

The conflict has come at a point when economies in developed and emerging markets are looking vulnerable, Paolini says. Increasing geopolitical tensions, market volatility and weak earnings have therefore dampened investor sentiment.

This brings the argument back to the reoccurring theme of quality. "With developed market economies slowing down, we continue to prefer quality stocks – companies with high profitability, good earnings visibility and low leverage – and defensive stocks, and retain our overweight in consumer staples and the Swiss market," Paolini says.

Despite the gloomy economic outlook, he maintains an overweight stance on emerging economies. "These markets have better growth prospects than developed markets. We retain our increased exposure to energy, a defensive move in the light of heightened geopolitical tensions," he says.

But that gloomy outlook persists, given that the spectre of a recession still hangs over the market outlook. "Equities may face volatility from uncertainty around timing and depth of any potential recession, if and when it comes, and the fact that bonds have become a worthwhile yield alternative again," Bakhshian says. Hence, she believes investors should continue to be selective and "tilt towards high quality investments".

### Going global

The range of equity opportunities globally is fascinating. Bakhshian adds that looking at the recessions of 2002 and 2008, US small-caps outperformed large-caps in the early phases and, interestingly, the recovery, driven by more favourable starting valuations and pricing in recession risks, started earlier and more significantly.

"Currently, price-to-earnings ratios for US small-cap stocks are at levels typically seen during a recession, while large caps are more highly priced, driven primarily by mega cap growth stocks," she says.

Elsewhere in the global equity market, Bakhshian cites China as continuing to be the dominant driver within emerging markets. "Given the recent economic uncertainty and property market crisis, investors have been more cautious towards China," she says. Yet Bakhshian's view is we could be approaching the end of this apprehension.

And on other geographical areas, she adds: "Europe's valuations appear attractive and index concentration is low compared to the US, although both regions will have earnings risk if economic conditions deteriorate significantly," she adds.

**Debt markets are not fully out of the woods.**

Tapan Datta, Aon Retirement Solutions

Blackrock is big on Japan. "We turned overweight Japanese equities on potential earnings beats and shareholder-friendly reforms. We also tap into the AI theme in developed market stocks," Li says.

Tollette expects the Japanese market to deliver earnings growth of just over 8% through this year and next, the highest of any region globally: a nice number indeed.

Datta also likes this trend. "Japan and emerging markets have a bit more going for them in relative terms compared to either the US or Europe, similar to the way defensives should be favoured over cyclicals at the margin, as rates pressures ease with a slowing economic activity scenario playing out."

### The bonds picture

So what is the picture for bonds? Blackrock likes them, at least those issued across the Atlantic. "We like short-dated US government bonds and have also turned more positive on UK and euro area bonds where yields have spiked far above their pre-pandemic levels," Li says. "We also like emerging market hard currency debt."

Although she is steering clear of long-term US bonds even after their surge. "We think term premium – the compensation investors demand for the risk of holding long-term bonds – will rise further, pushing yields higher, as markets price in persistent inflation, higher-for-longer rates and high debt loads," Li says.

The recent history for bonds has been challenging, with periodic sell-offs, adding to a generally difficult last couple of years. "At the margin, the outlook for debt – in expected 'total-return' terms – has shown significant improvements given the sharp rises in yields through much of 2023, which suggests that after inflation return prospects for fixed income, and cash has improved," Datta says.

However, he cites two risks in debt markets that investors need to bear in mind. First, the battle over inflation is not yet conclusively won. There is still some possibility that after some welcome falls this year, progress in returning inflation to central bank targets stalls, or, in the US case, reverses if the economy re-accelerates, forcing more rate hikes from the Fed.

### Lurking risk

Though this still represents a lurking risk for bond yields, Datta believes in the slowdown narrative, so rates should not come under renewed pressure. The other risk comes from credit markets, where weaker economic conditions and the large rise in debt servicing and refinancing costs brings credit losses – defaults in lower grade bonds and downgrades in investment grade credit.

"In other words, debt markets are not fully out of the woods," Datta says. "That said, the bigger price adjustments in debt

> **Coupled with reduced credit availability, we expect that corporate profitability is going to be squeezed.**
>
> Sriram Reddy, Man GLG

markets and high cash rates make it harder to like equities. Equities have some of the lowest relative attractions versus bonds in the past two decades at current valuations," he adds.

Tollette says the higher starting level for base yields now offers a much more appealing entry point for bonds. "They are no longer return-free risk as they were for much of the recent decade and again offer a competitive alternative to equities.

"In the medium term, yields will likely fall back a little, offering modest capital gains for longer-duration bonds," he says.

## Enticing yield

Emma Wall, head of investment analysis and research at Hargreaves Lansdown, says gilt funds are topping the popularity table for investors. "Enticing yields are offering investors with a five-year view the chance of a real return over inflation," she says. This is because after a decade languishing at near-zero rates, government bonds offer an exciting opportunity for income seekers. "This environment looks set to stay," Wall says. "Higher for longer rhetoric has been repeated by the Federal Reserve and the Bank of England, though chances of another hike by either central bank have dwindled."

This means a return to a more traditional portfolio. "Investors should therefore ensure they have a balanced portfolio, with assets for growth, income and income growth – that is, well-covered dividends, in their portfolio," Wall adds.

But like many forms of investment at the moment, the bond picture is not always easy to assess. Jeffrey Cleveland, chief economist at investment boutique Payden & Rygel, says the bond market seems to imagine the world in only two states. "One where central banks are hiking and the other where they must be cutting, if they are not hiking," he says.

Cleveland says he can imagine a third state, one where central banks do nothing, that is to remain 'on hold' for the next six months. "The US Fed, for example, spent much of the mid-1990s in just such a state, as well as a long stretch from 2008 to 2016 spent at zero," he says.

## Sovereign exposures

There are some unexpected – or possibly actually expected – attractions in fixed income. Fedeli finds the long end of the developed sovereign bond markets – including 10 and 30-year government debt issued by the US, the UK and Germany – more attractive following the recent price sell off.

"It is always difficult to find the perfect entry point in the midst of market volatility," Fedeli says. That said, she adds: "With the Fed closer to the end of its hiking cycle, historically this has been a precursor of peak rates at the long end of the curve. The long end of the curve also serves as an 'insurance' should a macro-economic slowdown ahead be more significant than the market expects."

Investors should also consider another scenario, one in which central banks, after a pause period, do not cut, but instead hike again. This is slightly contrarian, as policymakers have clearly indicated the next move is lower. Yet Fed chair Jerome Powell has said the Fed maintains its hiking bias.

"Many bond traders think lower inflation soon is a foregone conclusion, but we are more sceptical," Cleveland says. "Central bankers will want more than a bond trader's hunch that the inflation dragon has been slayed before changing course."

More to the point, it will not be the hopes of bond traders and policymakers that ultimately determine interest rate moves in 2024 – it will be the cold, hard facts of economic reality. "At least with regard to the US, GDP and employment growth are still above trend, and core inflation more than double the central bank's target," Cleveland says.

## Look for quality

If the threat of rate hikes is indeed done, interest rate volatility should decline. Government bonds will undoubtedly benefit, but so will everything from high-yield corporates and agency mortgage-backed securities, hurt by higher rates and higher rate volatility, to emerging market debt. In a soft landing, the US dollar should soften providing global relief.

Franklin Templeton has therefore, Tollette says, retained a preference for high-quality government bonds, but also see investment-grade corporate bonds as appealing. "Corporate bond spreads have increased recently but may not fully reflect the anticipated increase from low default rates, reducing the appeal of lower-rated sectors such as high yield," Tollette says.

A point shared by Sriram Reddy, managing director of credit at Man GLG. "Given elevated yields in fixed income – which remain at over decade highs – investors should be encouraged by the attractive opportunity set to generate attractive risk-adjusted returns."

That said, given the uncertainty that still remains in the market, Reddy says it is the time for investors to be selective. "Monetary policy remains tight and is likely to remain so for the foreseeable future. Coupled with reduced credit availability, we expect that corporate profitability is going to be squeezed," he adds.

### Under the surface

Against this backdrop, Reddy sees some opportunities in credit markets, but believes that an active approach is crucial to source opportunities that may already be pricing in recessionary risks. "The reason for this is that when we consider broad corporate indices on aggregate they seem to be pricing in a soft landing type outcome, yet, when looking below the surface we see a barbell of some expensive names and some that look cheaper and are already pricing in recessionary type outcomes."

He sees value in owning duration, something that will chime with many institutional investors. "Both for the potential portfolio diversification benefits and the potential total return in investment grade credit," Reddy says.

He also sees "selective opportunities in high yield and emerging market corporates where the valuations look appealing, particularly compared to equity markets". Additionally, Reddy adds: "The significant amount of income that investors can generate can potentially protect against significant drawdowns over the medium term, even if spreads widen from here."

### US spreads

Pointing in another direction, Matthew Dunleavy, client portfolio manager of fixed income at Principal Asset Management, says that US credit spreads have proven resistant to widening during 2023. "Part of the reason for that has to do with the appetite investors have shown for yield. As yield has become the backbone of bond investing, corporate debt buyers are capitalising on it," he says.

Dunleavy foresees that trend continuing to play out, especially amid a higher-for-longer rate environment. "In fact, the longer rates remain elevated, the sharper the focus and larger the appetite of yield buyers, which, in turn, begets bond buying," Dunleavy says. "With spreads at the tighter end of their recent range, spreads are likely to start to drift wider as signs of a more material economic slowdown becomes evident."

In this environment, Dunleavy adds that high-quality fixed income will continue in all likeliness to deliver attractive returns on a risk-adjusted basis, as the Fed maintains its higher-for-longer rate stance. "Most fixed income asset classes should fare well, supported by attractive yields and resilient fundamentals," he says. Moreover, he believes the market environment for investment-grade investors should remain "enticing" heading into 2024, as higher yields are creating a technical tailwind for the investment-grade market and should bolster spreads.

In addition, high-quality, short-duration consumer asset-backed securities also remain a "compelling opportunity" for investors, while regulatory changes and rate stability driven by a pause in the Fed hiking cycle should produce "increased bank demand for mortgage-backed securities" over the longer term. Furthermore, despite an anticipated economic slowdown, at least in some markets, Dunleavy does not believe investors should shy away from high-yield credit. "Some areas of the high-yield market present an advantageous long-term risk-reward profile due to strong corporate fundamentals and a receptive primary market," he says.

### Goodbye Goldilocks

But other more fundamental factors are at play that will impact the market outlook. Mitesh Sheth, chief investment officer of multi asset at Newton Investment Management, highlights that investors are facing a new era. "We have had 15 years of a goldilocks market, where interest rates and inflation were low and the world was characterised by globalisation."

But this is changing and inevitably, will have an impact on the economic and investment fronts. "We should forget about the type of inflation regime we have seen in our working lifetime," Sheth says. "We expect higher structural inflation and more volatile inflation [going forward].

"It is why there is much disagreement between economists and investors," he adds. "That is because if you look through all of this, our view is that equity markets should be lower. We are expecting a selloff in equities from here.

"Our view is that in the medium term, all asset classes that have benefited from this environment are all likely to be overvalued and we will see some type of correction," he adds.

Therefore, the unpredictable may well give way to a truly new form of challenge.

**We should forget about the type of inflation regime we have seen in our working lifetime.**

Mitesh Sheth, Newton Investment Management

# GEOPOLITICS IN 2024: THE YEAR OF LIVING DANGEROUSLY

The economic and political outlook poses many problems on many fronts for investors. *Andrew Holt* cuts through the uncertainty to find out where investors should be looking.

"Events, dear boy, events," was the reply former prime minister Harold Macmillan gave when asked what are the greatest challenges facing a statesman. That famous quip could well apply to institutional investors today looking at the tumultuous economic and political outlook facing them.

There is no doubt that it is not just the events, but the number and scale that present a great deal of investor concern. In fact, it is quite unique that so many large events have converged at once: global economic uncertainty, war and geopolitical tensions stand out as likely to shape the approach of investors in 2024 and beyond.

Let's begin with the worst-case scenario. And this is potentially very bad. This involves a world war. This would have seemed hyperbole a number of months ago, but the geopolitical heat has been turned up to scorching by the Israel-Hamas war. It presents a highly fraught geopolitical situation. Every major geopolitical player stares off against another major opponent in this war scenario.

Ray Dalio, the founder of Bridgewater Associates, the world's largest hedge fund, has warned that the Israel-Hamas war marks "another step toward international war".

"It appears to me that the odds of transitioning from the contained conflicts to a more uncontained hot world war that includes the major powers have risen from 35% to about 50% over the last two years," he wrote in a commentary. "These types of brutal war are more likely to spread than subside," he said.

## Investors and impact

This is a dangerous outlook. If correct, it poses a major test for investors. Tom Stevenson, investment director at Fidelity Inter-

national, has summed up his thoughts on how investors deal with such events. "Investors are generally not very good at understanding the impact of terrorism, war or other geopolitical developments, even ones that have decades of precedent from which to learn lessons," he wrote in a commentary.

So where should investors at least start? "They should anticipate that, from time to time, bad things will happen, and they should regularly test what could go wrong with their portfolio, but also what could go right," Stevenson says. "They should ensure that their portfolios are well diversified, across asset classes and geographical regions, to minimise the likely impact of a flare-up in any one part of the world."

There are points that investors can identify in an escalation scenario, says Richard Bullock, senior research analyst of global macro-geopolitics at Newton Investment Management. "The bigger risk for markets would arise if the [Israel-Hamas] conflict escalated to draw in regional powers such as Iran and Saudi Arabia, countries that also control significant volumes of oil supply," he adds.

"Should the conflict persist, and the US become involved through weapons support to Israel, this would be likely to lead to further escalation and could draw in other great powers," Bullock says. President Biden and his secretary of state, Antony Blinken, have been busy making statements about the need to avoid escalation for this very reason.

### Muddy waters

Stepping back from the brink of war and addressing the mundane economic outlook for the UK and the rest of the globe, the situation is as clear as mud given that disinflation, deflation, inflation or stagflation all remain possible outcomes.

The focus is back on the Middle East, which could create a global inflation problem. "An escalation of Middle Eastern conflict could provide an additional source of inflation just as global central banks are beginning to show progress in getting inflation under control," Bullock says, before adding: "The dynamics could be eerily reminiscent of the 1970s."

The spectre of the 1970s haunts many outlooks. This is true of Shweta Singh's view, with the chief economist at Cardano's outlook showing a higher global interest rate environment starting to bite, tighter credit conditions weighing on housing markets and on corporations' capital expenditure plans as well as on consumer activity. Furthermore, evidence indicates that corporate bankruptcy rates have started to climb.

"The prevailing consensus may be overestimating the strength of the present underlying growth momentum," Singh says. "Accordingly, while our expectations are pushed out a little further into the future, we expect the onset of a US recession in mid-to-late 2024."

> **Equity markets start the year too high in our view.**
>
> Shweta Singh, Cardano

Ahead of this downturn in the US, Singh expects a recession to commence in the UK, and in the euro area too, a little earlier in the year to come. This is not as bad as a world-war scenario, but it is pretty grim, nonetheless.

### Back to the 70s

This means Singh sees the upcoming US presidential election and possibly a UK General Election in 2024 being held in the immediate aftermath of domestic recessions, a pretty unprecedented picture. Except, of course, the relevant comparison is the return of a 1970s scenario, which keeps rearing its head.

"Should 2024 play-out according to our expected pattern, a real dilemma will face the world's central banks," Singh adds. "While inflation is set to fall, it will remain elevated relative to central bank targets. Premature easing – a traditional countercyclical monetary policy response – risks giving away the gains made by the past tightening cycle."

Here he therefore asserts that he is "very much in the higher for longer camp" and, accordingly, sees the overall interest rate environment as being a headwind well into 2024.

"Shallow post-recession recoveries are expected," Singh adds. "Importantly, we don't think that corporate earnings forecasts nor price-to-earnings ratios properly reflect this outcome. Equity markets start the year too high in our view."

The geopolitical situation beyond the Middle East will also be big influence during the next 12 months. Daniel McCormack, head of research at Macquarie Asset Management, cites two ways this is likely to play out in 2024. The first is in China-US relations. The second is the US election, set to take place in November, most likely between Donald Trump and the incumbent Joe Biden.

### Great powers at play

On the first, McCormack says: "We are entering a period of great power rivalry where a rising power [China] is increasingly challenging the incumbent [the US]. Increasing trade tensions, greater use of industrial policy, investment restrictions and greater geopolitical tensions could all result, all of which could impact economic outcomes and returns."

On the impact of the US election, he says: "Elections usually don't matter much for investors," before adding: "If the US moves in an isolationist direction after next year's election – not guaranteed but possible – this would have profound implications for the international order and huge knock-on effects for the US' allies and adversaries alike."

In the longer term, the global economy could experience deglobalisation and slower supply side growth. "Slower or reversing globalisation, sluggish productivity across the developed world and demographics that are increasingly biting are resulting in slower supply-side growth for the global economy," McCormack says.

In essence, more links to the 1970s: meaning more inflationary pressure globally, slower GDP growth and weaker returns across all equity asset classes over the next decade or so.

In the near-term, there are for McCormack three main scenarios for investors, and they all hinge on the US: a US soft landing, a mild US recession and a severe US recession. "These will all have different implications for interest rates and risk assets. However, we believe a mild recession is the most likely to the three," he adds. It is bad news when that is the best news.

### Russia's having a gas

Jose Pellicer, head of investment strategy at M&G Real Estate, also identifies geopolitical risks on different fronts. Firstly, there is Europe. "Western-friendly nations bordering Russia as well as other European states previously heavily reliant on Russian gas imports now carry a higher risk tag," he says.

In addition, like others, Pellicer says conflict in Ukraine and an escalation of tensions in the Middle East are likely to have a negative impact. But he cites specifics: with an impact "on commodity prices and construction costs and could well result in greater investor caution when considering developments," he says.

And then there is Asia, which inevitably includes America. "Worsening political relations between the US and China – and their respective allies – are likely to have economic consequences," Pellicer says. For example, Pellicer cites specific regulatory changes within China itself "which could make it more difficult to divest or repatriate existing overseas investments in the future."

Pellicer also subscribes to the school that does not expect rates to fall anytime soon. "We have entered a new era where interest rates will be higher for longer. For now, there is no going back to the lower rates of the last decade."

Not exactly a return to the 1970s, but more of a clear fork in the road that creates new challenges for investors.

Investors, therefore, will need to adapt, with recession remaining a real threat in some markets. "We may also start to see a more defined, two-bloc global currency scenario with the long-term dominance of the US dollar and associated currencies challenged by the Chinese yuan," Pellicer says.

### Fiscal fluctuations

Investors should also keep an eye on fiscal shifts, according to Daniel Morris, chief market strategist at BNP Paribas Asset Management. "Beyond global economic uncertainty, war and geopolitical tensions, investors should closely monitor fiscal policy changes, such as potential adjustments in the primary fiscal deficit in 2024," he says.

Additionally, he notes other economic and political areas to keep an eye on. "Factors like the impact of monetary policy tightening, changes in credit provision and the winding down of subsidies for climate change as well as infrastructure, microchip and electric vehicle investments in 2024 can significantly shape investor approaches," Morris says.

He then adds to his scenario list. "Investors need to consider scenarios involving further escalation in geopolitical tensions, the continuation of quantitative tightening and the potential impact of a slowdown in credit provision," Morris says. "The scenarios should also account for variations in long-term treasury yields, potential shifts in central bank policies and the evolving dynamics in sectors like technology, driven by artificial intelligence-related investment booms."

### Rethinking geopolitics

But for Tapan Datta, partner in global asset allocation at Aon Retirement Solutions, we need to keep geopolitics in perspective. "A note of caution is needed which is that it is easy to overstate the importance of geopolitical events on market conditions," he says.

"While lots of major market moves have been occurring since the outbreak of hostilities in the Middle East in early October,

**The dynamics could be eerily reminiscent of the 1970s.**

Richard Bullock, Newton Investment Management

“

**The utter lack of trust in our political institutions right now runs the risk of bleeding over into the investment realm.**

Daniel Peris, historian

the conflict cannot be held responsible for them. The lesson is that unless geopolitical conflict impacts the major global growth engines – G7, or at the very least, G20 – markets will typically decide to ignore them,” Datta says.
However, he notes that markets will take notice if there are simultaneous geopolitical events that could in combination bring a “material” impact. “A dual escalation of the Ukraine war and a widening Middle East conflict, to take an example, will be much harder to bypass,” he adds.
While acknowledging that there is no shortage of geopolitical event risk that would have the potential to destabilise markets in 2024, Datta says: “Their impact would have to be assessed on a case-by-case basis.” So on this outlook, we should not get carried away.

### The importance of America

He instead makes the point about the importance of the US economy as a global growth engine, making impacts involving the US more material to markets. Essentially, some geopolitical players are more important than others.
“An escalation of US-China tensions beyond the current ‘cold’ technology war and a return to power of Donald Trump in the US presidential election late next year are two that come to the forefront when considering such market-moving event risks,” Datta says.
One of the more destabilising possible scenarios would be a combination of economic and geopolitical events that bring significant impact. Taking one example, even though a possible second Trump presidency only takes effect in 2025, markets will attempt to anticipate those effects much earlier, Datta says.
“If the likelihood of this happening looks to be increasing through 2024, markets will react weeks or even months before the November election,” he says. There is a high element of unpredictability here on what policy changes will happen in 2025. But Datta has a stab, looking at the potential outcomes. “If the US economy is already struggling under a prolonged period of high interest rates, the raised probability of a new round of unfunded tax cuts could destabilise the US bond market – given its strong disquiet over existing large fiscal deficits – driving yields higher, amplifying negative trends in the US economy,” he says.

### Parallel scenarios

This scenario offers an interesting parallel with the ill-fated Truss prime ministership in the autumn of 2022. In a similar vein, a major ramp up of US defence spending that becomes necessary to contain conflicts in other parts of the world could also bring problems in rates markets for similar reasons.
Datta then adds additional observations on risk scenarios and how investors should react. “It is worth noting that any rise in uncertainty over event risks that could be material to global economic conditions comes through inevitably in higher market volatility which investors would be wise to allow for as a kind of ‘sidebar’ to considering event risk in markets,” he says.
Datta also notes there are a number of economic scenarios that could be troubling for markets even if geopolitical conditions turn calmer. “For instance, the impact of the big rise in interest rates in 2022/23 is yet to fully feed through and is still somewhat unpredictable. Investor caution on this is well warranted when it comes to assessing the risk of things going wrong that would bring about a significant economic downturn or recession.”
Of course, it is also true, he adds, that the global economy could muddle through, with geopolitical risks staying on the sidelines. “Which is perhaps the best scenario to hope for. As usual, investors need to consider the possibility that things go right rather than wrong, just to keep perspective,” he adds.

### Risks and opportunities

Whether it is geopolitics or a replaying the 1970s, it is a challenging environment for investors. A challenging macro-economic backdrop doesn’t mean a dearth of investment opportunities. Quite the opposite, says Wei Li, global chief investment strategist at the Blackrock Investment Institute.
“Higher macro volatility is translating into greater divergences in security performance relative to broader markets. That calls for much greater selectivity and more granular views,” she says. “Harnessing forces shaping our world will also offer abundant investment opportunities. It all boils down to what’s in the price.”
But the higher for longer issue is also important for investors, Datta says. “We have moved into a lasting environment of

higher interest rates than those seen in the past decade, the full economic and market drags of that will take time to feed through which argues for a more careful approach to investor risk-taking," he adds.

"At present, it is hard to argue from current market pricing that particularly negative outcomes are being allowed for," Datta says. "A broad spread of investments with moderate risk taking – somewhat below normal allocations to risky assets – and building in some protection from adverse scenarios through less market-sensitive strategies looks sensible for 2024."

Like many, Datta sees private markets offering opportunities. "Private markets are still in the process of lagged adjustment to developments in public markets, but much as with public markets, debt should be favoured over equity on the basis that after inflation return prospects have improved considerably in the past 12 to 18 months." However, he notes the extent of underlying credit risks taken will need close monitoring.

### The biggest prize

Then there is what Daniel Yergin termed in his book the biggest prize: oil. Given the new global environment, oil price forecasts have been revised, says Gonzalo de Cadenas-Santiago, executive director at MAPFRE Economics, seeing an increase to an average of $87 (£70) per barrel, giving way to a fourth quarter peak of $101 (£81) per barrel by the end of the year.

In turn, he notes, a simulation of a higher long-term trajectory returns an average that remains above $90 (£72) per barrel in 2024 and a later convergence in the medium term.

"This assumption results in a more pronounced period of stagflation in 2024, but with more significant implications for economic activity than for price dynamics," de Cadenas-Santiago says.

"The stressed scenario assumes a more pronounced and sustained oil price shock for most of 2024, due to worsening tensions in the Middle East," he adds. "This supply shock translates into a more rigorous stagflation outlook, with implications for economic activity and price dynamics."

> **The stressed scenario assumes a more pronounced and sustained oil price shock for most of 2024, due to worsening tensions in the Middle East.**
>
> Gonzalo de Cadenas-Santiago, MAPFRE Economics

### Shareholder challenge

Daniel Peris, historian and author of the soon to be published *The Ownership Dividend*, says the political and economic trends and influences we are seeing should be put in a wider context.

"Milton Friedman's shareholder capitalism is being challenged by a broader European stakeholder approach taking into account factors beyond just capital returns," he says.

Peris' view is that on-shoring, friend-shoring, and near-shoring mean the model of "extreme globalisation" will have to be altered. "Expect to see more local and national, and less global. Expect more regulation rather than less regulation," he says.

As with much of the outlook going forward, the political situation in the US is going to be fundamental. "The politics in the US may end up being the most important one for investors," he adds. "The utter lack of trust in our political institutions right now runs the risk of bleeding over into the investment realm."

Offering a further warning, Peris says this trust factor in the new political economic paradigm will play out over years, if not decades. It is no passing fad. In the meantime, from a narrower US stock market perspective, more specific outcomes associated with the end of the so-called neo-liberal order are likely.

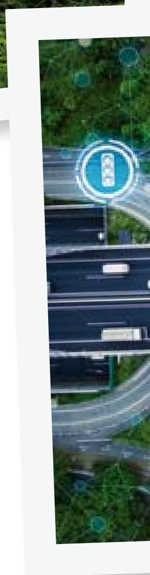
The first is consistent with the end of interest rates declining. "The resulting return of material risk rates will leave less room for the tricks of the trade that became so common during the final decade or two of the prior order: special purpose acquisition companies, unicorns, and accounting shenanigans to optimise earnings per share should become scarcer," Peris says. "Some mean reversion in US corporate margins from the advances of the past two decades is also likely."

And then there is the idea of the cash nexus. "The end of declining interest rates on its own will mean assets will need to compete on a more normal cash-yield basis," Peris adds.

But the new political economy will provide another reason for an improved cash nexus of investment: a different level of trust. "The post-neo-liberal order will likely entail less trust in corporate executives, and greater insistence by investors on a tangible return for their capital," Peris says.

This all results in a near future where investors face numerous risks to navigate but opportunities also exist if investors look hard enough, amidst the turmoil.

# PRIVATE MARKETS: AN ALTERNATIVE LOOK AT 2024



Direct lending, property and infrastructure offer a world of opportunity for those looking to give their portfolio an alternative edge. But what will the investment case for private markets look like in 2024? *Fiona Nicolson* reports.

The investment case for private markets will be a lot stronger entering 2024 than it was 12 months earlier.

At the start of 2023, private markets could be summed up as unsettled. In an overview published in February, JP Morgan said investors were “grappling with real uncertainty” against a backdrop of volatility and recessionary fears.

But by the summer, the outlook was brighter. Goldman Sachs private-markets research, which surveyed more than 200 limited partners (LPs) and general partners (GPs) across the Americas, APAC and EMEA, revealed a more positive mood. Almost two thirds (64%) of respondents reported improved investment conditions and 22% said these were stabilising.

Looking ahead to 2024, David Hedalen, head of real assets research at Aviva Investors, agrees that the landscape has been improving. “The fog which existed over the private markets space a year ago has started to lift,” he says. “Our central view is that we are at, or close to, the top of the central bank hiking cycle and inflation, in the main, is coming under control.”

Rob Martin, global head of investment strategy and research at LGIM Real Assets, says: “Optimism for private-market investments across institutional investors has continued to increase over the past year.

“We believe that many of the most pressing trends that could influence the investment environment can be traced back to one of four megatrends: demographics, decarbonisation, digitalisation and decoupling,” he adds.

Reflecting on what might happen in the private-markets universe next year, Hedalen says: “Activity will start to recover, as interest rates are expected to fall in late 2024, which will encourage investors out of cash and back into private markets.

“Returns in the private-debt space, across real estate, infrastructure and private corporate debt, remain attractive on a risk-adjusted basis. We expect this to continue into 2024.”

## Asset classes and allocations

The largest average allocations reported over the summer were buyouts (12.2%), private credit (10.1%), real estate (9.6%) and infrastructure (6.4%), according to the Goldman Sachs survey.

Going into 2024, private credit looks set to retain its popularity, as Matthew Williams, head of institutional EMEA at Franklin Templeton, explains: “Private credit continues to be a preferred asset class for institutional allocators.

“Regulatory dynamics globally have led to reduced bank lending in private-credit markets, which is increasingly being replaced by private lenders. Secular and cyclical themes support the emergence of private credit as a core alternatives allocation. Disruption in the syndicated leveraged loan market, in addition to recent banking sector challenges in response to the rapid increase in short rates, has accelerated this trend.

"Healthy credit spreads and tighter underwriting standards in most private-credit markets reinforce the high demand we currently see for this asset class," Williams adds.

Private credit is also flagged by Adam Lygoe, head of institutional and international wealth distribution at Macquarie Asset Management. "We have witnessed a strong interest in private credit, given the number of supportive tailwinds," he says. "Going into 2024, we expect to see allocations being switched to private credit as an alternative to equity."

He adds that the macro environment continues to demonstrate the role infrastructure can play in portfolios. "Indications are that the general trends of the past several years around increasing client allocations to the sector over the medium to long term are likely to continue."

In its H2 2023 alternative assets investor outlook, Preqin reported that private debt "continues to shine". The data company also noted that according to its investor survey, private debt is the only asset class where most LPs expect returns to improve in the next year – and the only one in which a majority plan to bump up their allocations. Nearly all (90%) of respondents said it had met or exceeded their expectations over the past year.

While debt markets may look attractive, some areas need to be scrutinised with particular care, Hedalen says. "From a risk-adjusted perspective, debt yields remain at compelling levels. This is a great opportunity to lock in higher rates across infrastructure debt; real estate debt; and private and corporate debt.

"We are more cautious about sub-investment-grade debt in a tighter credit environment; investors should tread more carefully here and favour high-conviction companies and sectors. That said, we feel there is value to be captured in certain areas.

"We believe that this year and 2024 will be good vintages for commercial real estate," he adds. "Caution, however, is required in the office sector, particularly average to weaker quality, where there are material headwinds in many markets."

Jo Waldron, head of client & solutions, private credit at M&G, also alludes to private debt. "In the current stagflationary environment, central banks have maintained a somewhat vague stance on peak interest rates," she says.

"Yield curves have gyrated significantly over the year, and we believe there is value in maintaining duration neutrality in this uncertain environment," she adds. "We see value in defensive, senior, secured, floating-rate private debt which currently offers potential 'all-in' yields of around 10% without the need for taking undue credit risk."

### The impact of recession and inflation

Macro-economic challenges such as geopolitical conflict, interest rates and inflation were three of the main risks flagged by the respondents to Goldman Sachs' survey. But recession topped the agenda with almost half (48%) expressing concerns that it may be on the horizon.

> **The fog which existed over the private markets space a year ago has started to lift.**
>
> David Hedalen, Aviva Investors

More than three quarters (77%) said they expect a US recession in the next two years: 23% thought it would come this year and 53% anticipated its arrival during 2024. When considering the eurozone, almost all (90%) expect it to land in the UK – either this year (42%) or in 2024 (44%).

And as 2024 approaches, concerns about recession and the impact of inflation linger. "Our central case remains a recession for the US, Europe and UK in H1 2024, as higher interest rates start to squeeze disposable income and corporate margins," Martin says. "Our conviction is strengthened due to central banks' inability to respond quickly because of high inflation and the current strength of the labour market.

"Weaker GDP growth is likely to lead to lower demand for cyclical businesses and the more economically sensitive areas of real estate and infrastructure, such as offices and transportation."

However, Hedalen says: "Our central case is that there will not be a recession within the UK or the eurozone in 2024, but there will be a period of low growth as restrictive policy rates continue to feed through into economic activity."

### Cautious valuations

Despite increased levels of optimism around private markets, there is still a degree of uncertainty when it comes to the outlook for valuations in 2024. Lygoe says: "Private market investors continue to take a cautious approach to valuations, with a range of factors including deglobalisation, geopolitics, trade tensions, protectionism, and reduced monetary and fiscal policy flexibility all contributing to that caution."

Waldron also anticipates some challenges, as she explains: "Although it is likely that private-market valuations will continue to be better insulated from broader macro-economic volatility, defaults are likely to peak next year."

She adds: "Most companies within the private-debt space have successfully navigated higher debt obligations, with many starting the year with decent fundamentals and the majority of near-term debt refinanced. Borrowers have worked flexibly with lenders to build customised funding solutions; however, now is the time where we will start to see the winners emerging."

Mikko Iso-Kulmala, head of private credit solutions at Fidelity International, says: "At the moment, we are still seeing a gap within private equity between entry and exit valuations, but we expect these to continue to converge. There is a lot of talk around private-market valuations in general and some of the existing deals in current portfolios may need valuation revisions as funds come towards the end of their lives.

"Beta and floating rate have generally performed well this year, with duration having suffered," he adds. "That said, more recently we've seen a bit of a correction around spreads moving wider across all risk assets, so any entry point from now on to year end as well as early 2024, broadly stating, should be at historically attractive levels."

## The impact of ESG

The limelight is likely to continue to shine on ESG in 2024, believes Rafael Calvo, managing partner at MV Credit. "There is no question that sustainability and diversity and inclusion will remain high on global corporate agendas in 2024," he says.

"We expect to see asset managers and private investors alike appreciate ESG-focused, private-debt managers. This in turn will influence investment decisions in the coming months."

Emmanuel Deblanc, global head of private markets at AllianzGI, also anticipates a continuing focus on ESG, particularly the S. "ESG will remain a key pillar, but we expect to see a stronger focus on diversity," he says.

But Deblanc adds that the quality of data, which is needed to allow transparent reporting and monitoring, will be key. "There will be more pressure on institutional investors to show more progress with this."

Returning to the megatrends that could influence private-market investments, Martin says: "The acceleration of decarbonisation efforts should create vast demand for new asset creation, as well as initiatives to support climate adaptation and energy efficiency.

"The European energy transition alone represents an €840bn (£666bn) opportunity for investors looking to deploy capital into sustainable infrastructure," he adds. "We see strong investment opportunities for wind and solar farms, battery storage and, in time, power-network infrastructure, which is required to ensure increased renewable capacity is effectively integrated into the energy system."

## The impact of AI and data science

While ESG remains high on the agenda, there is a new acronym in town. Goldman Sachs' survey revealed that over the next five years, the greatest drivers of alternative-investment evolution are expected to be Artificial Intelligence (AI) and data science, cited by a third of respondents.

"AI and data science are going to have a significant impact in the long term," Calvo says. "Having said that, over the next five years we are going to see an increase in the regulation of AI, which in turn will somewhat slow down the speed of the advance we are experiencing now.

"However, we believe that AI and data science will help significantly with due diligence and the investment process; the collection and monitoring of ESG KPIs; and the improvement of the investor experience."

Iso-Kulmala also anticipates positive developments. "We expect AI and data science to make existing processes more efficient, for example, by using GPT/large language models to consolidate, analyse and summarise vast amounts of existing research and pool it into quick snapshots of essential information. This approach will be able to draw insights from disparate sources of information on past and present deals.

"It will also allow for less reliance on, or in some instances, full elimination of manual processes for reconciliation and forecasting, by consolidating data from various sources and having the ability to interpret data formatted and itemised in different ways."

He concludes that this will free up peoples' time to "focus on 'value-add' tasks while automation streamlines more mundane and systematic matters, thus ultimately increasing the efficiency of the investment process".

It appears that private market assets appeal to long-term investors and they have plenty of economic and real world exposure to consider in 2024.

**Going into 2024, we expect to see allocations being switched to private credit as an alternative to equity.**

Adam Lygoe, Macquarie Asset Management

# pi ESG CLUB

***More and more institutional investors are making commitments to fighting climate change and nature loss or promoting greater equality. But what themes will investors be discussing with their investment managers in 2024? To find out, we asked the members of our ESG Club.***

Members

AON | BlackRock | BNP PARIBAS ASSET MANAGEMENT | JUPITER ASSET MANAGEMENT | LGIM | Manulife Investment Management | NEWTON Investment Management | PENSIONS AND LIFETIME SAVINGS ASSOCIATION

# ENGAGEMENT NEEDS TO IMPROVE - REVIEW

**Investor group highlights areas where asset managers are failing on stewardship. *Andrew Holt* reports.**

The UK Asset Owner Stewardship review has warned that there is a misalignment and misunderstanding of the importance of stewardship between asset owners and asset managers – with the latter coming under the spotlight for their stewardship failings.

The review, conducted by the UK Asset Owner Roundtable, which comprises asset owners and asset managers, offers five potential explanations for the misalignment.

The first is attributed to cultural/political misalignment. The participating asset owners are all UK based, while most participating asset managers are not, which may lead to a slight "cultural misalignment," said the review.

The second is a misunderstanding on the relevance of stewardship and voting, or the urgency of climate change as a key priority theme within stewardship.

Third is a misunderstanding of fiduciary duty itself. Therefore, following the prudent rule, asset managers should target a high, or even "optimised return per unit of risk ratio," commented the review.

Then there is a "conceptual disagreement" as to the most effective combination of stewardship processes. From the voting patterns revealed in the review, it is evident that some asset managers appear to see voting and engagement as mutually exclusive while others view it as much more complementary.

The final point concerns governance – as asset managers and/or financial firms owning them tend to have many "more commercial relationships with the issuers" than the asset owners whom the asset managers serve, said the review.

This means there are big challenges for the Asset Owner Roundtable to address going forward on the all-important issue of stewardship.

## Long-term interests

The aim of review has been defined as the need to understand how "asset owners' long-term interests have been served by their managers" when exercising their stewardship and proxy voting at major oil and gas companies within the global universe of the Transition Pathway Initiative (TPI).

Specifically, UK asset owners have been concerned that despite unequivocal warnings from the United Nations and the Intergovernmental Panel on Climate Change about the risks of delayed action on climate change, short-term interests of asset managers may be trumping the long-term interests of pension funds.

To address these concerns the review explored two crucial areas. First, it studied the actual votes cast by asset managers between 2015 and 2023 for TPI universe oil and gas companies and correlated them with the equal-weighted average of asset owner voting as contributed by the 10 participating asset owners.

Second, it reviewed the voting rationales provided by asset owners, with asset managers misaligned with asset owners.

## Big insight

Here the review revealed three trends. One, only selected asset managers "publicly reason" like asset owners.

Two, some asset managers somehow see voting and ESG engagement as mutually exclusive and appear to fear the loss of access to management if they vote against them.

And third, among asset managers, there appears to be a substantial divergence as to their interpretation of shareholders' and even society's interests.

The study also reviewed the ESG engagement success across all relevant issuers, which revealed three different engagement processes.

The first is so called "textbook", based on persistent, long duration, large-scale engagement with substantial progress.

Second is a "quick fix" style, with engagements characterised by less consistency, shorter duration and more mixed progress.

Third are the engagements defined as "jumping the bandwagon", as they appear to target only firms that already have been improved.

## Next steps

To address these points the Asset Owner Roundtable has set out three areas to address. The first is to explore the potential for extending this research to cover US asset owners.

Two, having one-to-one meetings between the UK Asset Owner Roundtable's members and their investment managers to discuss the voting decisions at global oil-and-gas company AGMs.

And three, set stewardship expectations for asset managers that will be developed by the UK Asset Owner Roundtable.

Leanne Clements, head of responsible investment for The People's Partnership, provider of The People's Pension, and member of the roundtable, said of the findings: "We have reached an impasse with respect to net-zero stewardship and we are running out of time."

She therefore added: "A complete dismantling of failed status quo approaches to stewardship is needed by the fund management industry, with voting escalation not seen as a last resort approach used on an exceptions basis, but rather a powerful signal to companies of what investors expect of them."

Faith Ward, chief responsible investment officer at Brunel Pension Partnership, and also a roundtable member, was more upbeat. "I am optimistic about the practical steps discussed, and the willingness of participants in the process to address the perceived gap verified by this report."

## ESG INTERVIEW – SARAH GORDON

# “There is still a misconception that delivering positive outcomes means you take concessionary returns.”

The visiting professor in practice at the Grantham Research Institute at the London School of Economics and Political Science (LSE), tells *Andrew Holt* about making impact investing universal, the need for an oversight unit in government, the benefits of blended finance and leaving your comfort zone.

**You have experienced the practitioner side of investment at the Impact Investing Institute and now look at ways in which investment can change the dial on ESG. What conclusions have you reached on how investors can create greater sustainability?**

It is encouraging that there isn’t an institutional investor who doesn’t think about ESG. They have different ESG approaches and the range is still broad, but 10 years ago there wasn’t much focus on what you could call ESG investment.

However, a lot of ESG is done through what I would call a ‘do no harm’ lens, rather than delivering a positive impact. And importantly, allocations dedicated to impact investing are tiny. We need a regulatory push to encourage institutional investors to dedicate more investment to positive outcomes. But some of that investment is achieving amazing results.

My research highlights that in the UK and emerging markets there are incredible examples of the impact that can be delivered alongside a solid financial return. There are also some fantastic examples of asset owners and asset managers working with local authorities to deliver positive social and environmental outcomes.

But they are not universal. And they are not at the scale to deliver the impact to really deliver, for example, on the government’s Levelling Up policy demands.

**Why are allocations to impact investing so small?**

There is still a misconception that delivering positive outcomes means you take concessionary returns. We need to park that perception. There is also an important blocker around fiduciary duty: the duty of investment managers to responsibly look after their clients’ money and that, for many decades, has been interpreted in a narrow way as delivering a maximum financial return.

And that has discouraged investors, like pension trustees, to think more broadly about what outcomes they are seeking to deliver from their investment decisions. We therefore need new guidance on fiduciary duty. The Impact Investing Institute, where I was CEO, and Share Action have come up with concrete proposals for what new guidance could look like.

**How could the government help channel capital from institutional investors into ESG investments?**

The work I have been leading at the LSE is advocating to the government: “Look, there is this real opportunity to mobilise private sector capital at scale for economic, environmental and social outcomes.”

Different pockets in some government departments are working with private investors. But there needs to be a commitment across government, and therefore, by central government to be much more ambitious about mobilising private investment for public policy outcomes.

You need a manifesto commitment by the leading political parties to do that. We also need an oversight function within government on this issue.

When we launched the Impact Investing Institute in 2019 the main question asset managers would always ask me was about the lack of standardised ESG and impact metrics. We should be encouraged by the fact that over the four years since, we have made enormous progress in moving towards much greater transparency and accountability across ESG.

We have had global developments like the International Sustainability Standards Board at the International Financial Reporting Standards Foundation – the first effort at global sustainability standard setting.

We have also had regulatory developments in a number of countries and regions. In the EU, the Sustainable Finance Disclosure Regulation, along with other regulations, has provided more demanding frameworks.

**What ideas have you put forward to government on this issue?**

One of the proposals in my report is for a growth fund. There is a lot of interest in the leading political parties around mobilising capital, particularly from pension pots. What I have examined in my report is the different approaches and outcomes that public and private investors seek, the process of working, whether the different goals of a private investor and a public investor can be reconciled and trying to give agency to public and private investors, which is important.

What concerns me about some of the proposals out there for a growth fund is that they don't necessarily respect the approach and the outcomes sought by different investors. I also talk about a UK community growth fund, because we need to channel far more private investment into the social enterprise and charity sectors. They are delivering fantastic positive impact and can deliver much more investment at scale. So I am proposing a blended finance expertise and oversight unit in central government, working across departments and with private investors, which could oversee both funds.

**How are pension funds doing in regard to ESG?**

As with the institutional investment industry more broadly, there has been a positive shift in pensions towards being serious about ESG factors and integrating them into their investment principles.

But it is more of what you might see as a negative screen, that 'let's do no harm', or 'let's have some exclusions,' rather than delivering positive outcomes.

And a lot of pension funds now have an explicit net-zero commitment, and some funds have been quite taken by surprise as to how much radical change that requires in their approach.

**Asset managers often cite their ESG commitments, particularly on climate. Are they substantive in your view?**

**What do you make of the backlash against ESG in some quarters?**

What I find particularly unhelpful is the idea that ESG is somehow anti-economic growth. That is the way the debate gets framed in the US and a lot of that is from a Republican pushback.

But it is broader than that. A lot of the pushback against ESG is that it is a liberal agenda that only the rich can afford. I would tie the renewable energy argument to the growth argument. Using more renewable energy will actually contribute to people's personal wellbeing and prosperity, which is incredibly important.

**Does the social side of ESG get neglected?**

There are many fantastic social impact investments going on. And in a way, the S pre-dates the E in terms of businesses and investors thinking about ESG.

If you take an organisation like the Co-operative Bank, for example, that was committed to ethical values and delivering positive impact – what we would now call positive social outcomes – a century ago.

The S has an amazing history, and for me, it is not E versus the S. The E and the S are incredibly inter-linked and inter-dependent. We need to be driving the E and the S and, of course, the G going forward, but at a much greater scale and with far greater urgency.

**The E is easy to define and measure, but that is not the case with the S.**

It is a problem to be grappled with, but around the social side a lot of work has been done to help investors think through the standards to look at. But the E isn't terribly easy either. Net-zero targets, while appearing to be simple, can be quite counter-productive.

If you look at the work of the Transition Plan Taskforce, for example, which is designing templates for transition plans, they have thought through how to think about the S as well as the E and how you integrate them. There is an increasing amount of guidance out there to help investors.

**You have been looking at how a potential Labour government could mobilise capital from pensions and other investors for a social benefit. What have you concluded?**

Rachel Reeves has come up with some incredibly exciting ideas for what a Labour government would do around mobilising private investment. One of the encouraging things is how the shadow cabinet is demonstrating a real willingness to work with the financial services industry.

That constructive collaboration, which seeks to work with the industry rather than against it, is absolutely critical in delivering flows of private investment towards the challenges that need that capital.

**How can blended finance help Britain catch up on its climate challenges?**

Blended finance is a broad approach. It means different investors, different types of capital with different types of risk and return expectations working together to deliver positive outcomes – whether that is a financial return, a socio-economic outcome or an environmental outcome.

> **A lot of ESG is done through what I would call a 'do no harm lens', rather than delivering a positive impact.**

The focus I take in my report is around the role that public money can play in providing catalytic capital, which then crowds in private investment. The Inflation Reduction Act in the US and the Green Deal and InvestEU in the EU are blended finance programmes using a range of tools, whether that is guarantees, tax credits, first loss capital or creating a market. The UK needs to catch up, as these programmes are putting it at a competitive disadvantage.

**Why did you move from impact investing to the academic world?**

At the Impact Investing Institute we worked to connect different parts of the investment spectrum to each other. For example, sharing the experience of social investors and the positive impacts they deliver, with mainstream investors. My work is still focused on doing that.

The project I am leading at the LSE is designed to encourage the UK government to be much more ambitious in mobilising private investment into economic, environmental and social policy priorities.

One of the key messages from the research which has just been published is how investors with different risk and return profiles, as public and private investors have, can collaborate closely to design financial solutions to pressing challenges like the climate crisis or social inequality.

So I don't feel like I have moved from practice to theory, but that I am continuing to encourage collaboration between different types of investors and move investment that delivers positive environmental and social outcomes more into the mainstream.

**What is the biggest lesson you have learned in your career?**

There are two. Firstly, push yourself out of your comfort zone. I have found this gets more difficult as you get older but have never regretted doing so. I left journalism after a nearly 20-year career at the *Financial Times* in 2019, to move into the world of impact investing, which required learning a new set of skills, and exercising some different professional muscles.

But I have found it enormously rewarding. In particular, because of the huge amount I have learnt from the great people I have had the opportunity of working with in the last few years.

Secondly, collaboration achieves more than confrontation. And collaboration only works if you engage with other people with kindness and respect. I wish I could say I always practice what I preach, but I do try.

**What are your aims for the future on ESG and personally?**

I hope that investors in the future will, as standard, take environmental, social and governance factors into consideration when investing in assets. Not just the 'do no harm' approach, but that we recognise, and maximise, the positive outcomes of our investment decisions as well as financial returns.

Personally, I hope to get the opportunity to continue sharing the benefits of sustainable finance in addressing the climate and nature crises as well as social injustice and encouraging and energising more policymakers to work closely with private investors to deliver sustainable and inclusive growth.

Nigel Peaple is the director of policy and advocacy at the PLSA.

# PLSA ASKS FOR SIX POLICY, REGULATORY AND FISCAL CHANGES TO ENCOURAGE FURTHER PENSION SCHEME INVESTMENT IN UK GROWTH

**Since early 2023 there has been considerable discussion by politicians, think tanks and the media on whether and how pension funds can be encouraged to invest more in the UK economy, especially regarding companies with the potential for high growth, albeit usually also at high risk.**

While it is imperative that pension schemes' freedom to invest in the best interests of their members, however they see fit, is protected, the PLSA has worked hard to identify specific policy reforms that could result in further investment in the UK, following the Mansion House reforms in July.

Introducing a number of regulatory and fiscal changes could bring benefits to pension scheme members and the UK economy, without the need for radical, highly disruptive changes to the operation of the UK retirement savings system.

Investment in the UK economy was a key topic for debate at the PLSA's recent Annual Conference in Manchester, and after consulting with a wide range of pension providers, policymakers, think tanks and other stakeholders over the summer, the PLSA has made policy recommendations to government in six key areas:

**Pipeline of assets:** Ensure there is a stream of high-quality investment assets suitable for pension fund needs. The British Business Bank should be given the task of identifying and providing UK productive finance assets that achieve the right risk-return characteristics and low cost needed by pension funds. These should not only include unlisted equities but also other illiquid assets such as unlisted debt and infrastructure. The government should also support action by the asset management industry in providing suitable growth funds or investment vehicles, such as the LTAF. We believe pension funds will be much more likely to invest in UK growth if the government adopts a strategic and long-term approach to supporting key industries, and key tasks such as the green transition to achieve net zero by 2050.

**DB regulation:** The funding regulations that apply to DB pension funds should be amended to provide greater flexibility over their investments. In particular, DWP regulations, and the related TPR DB Funding Code should allow open DB pension funds, and closed DB pension funds with long investment time horizons, to take more investment risk where this is appropriate to protecting member benefits. For example, the regulatory regime should allow pension funds to place more reliance on the support of the sponsoring employer, more flexibility over the discount rate used, and not force schemes to reduce the investment risk they take by aiming to achieve the "low dependency" funding level.

**Taxation:** Fiscal incentives should be introduced that make investing in UK growth more attractive than competing assets. We would like the chancellor to make the following changes: allow tax free dividends on investment by pension funds in UK companies, and provide additional tax incentives, like the LIFTS initiative, in UK startups and companies requiring late-stage growth capital.

**Consolidation:** The government should prioritise the passage of a Bill through Parliament to establish a secure and statutory regime which will enable the growth of DB superfunds. It should also take other action necessary to support the consolidation of assets in DB master trusts and with insurers through buyout and buy-in contracts. Measures to encourage the consolidation of LGPS (England and Wales) assets into the eight asset pools must only take place where the pools can offer the right investment products and it should be done at a pace that protects the value of the contributions paid in by employers and employees. The government should continue with its planned programme of action to encourage the consolidation of DC schemes, notably through the use of value for money tests.

**Market for DC under automatic-enrolment:** The operation of the market in which employers and trustees select their DC pension funds for automatic-enrolment purposes must be reformed so that there is less focus on cost and more on performance. Currently, a mandate can be lost due to a difference in annual charges of only a few fractions of a percentage point. Often, this lower cost is achieved by adopting a simpler, less sophisticated investment strategy. In addition to action already being taken by the government on introducing a value for money test, we believe the advice by corporate IFAs and investment consultants to employers on pension schemes should focus on net performance rather than cost and be aligned with achieving the long-term interest of savers.

**Raising pension contributions:** The UK must increase the flow of assets into pensions by gradually increasing the level of pension contributions under automatic-enrolment from today's 8% of a band of earnings to 12% of all earnings starting in the mid-2020s and finishing in the early 2030s. Today, employers only pay 3% while employees pay 5%; we believe this should be equalised so that each pays 6%. Raising automatic enrolment contributions in this way will provide a deep and lasting pool of investment assets for decades to come.

# ESG IN 2024

Regulation, natural capital and methane could be on institutional investors' agenda in 2024, says *Mark Dunne*.

ESG is not a passing fad. Institutional investors today are just as, if not more, committed to building sustainable portfolios that generate a positive impact on the natural world and promote equality than they were a decade ago. No longer seen as niche, such strategies are increasingly becoming a cornerstone of institutional portfolios.

Climate change has typically been the priority here, but other issues have emerged, such as providing access to fresh drinking water as well as adequate healthcare, housing and education. Then there is protecting our ecosystem, building resilient communities, ensuring that companies are well behaved and treat their employees with dignity and respect.

Building a sustainable and fairer world is a big job. Therefore, it is not surprising that new themes emerge in conversations between pension schemes and their investment managers.

Each year, *portfolio institutional* surveys the opinion of the members of its ESG Club to discover what they believe will be the big themes in the year ahead. One of those people is Laura Brown, who is head of client and sustainability solutions at Legal & General Investment Management (LGIM). She expects ESG-led investing to mature in 2024, in that there is likely to be increasing focus on real-world impacts and the outcomes investors are creating through their actions.

With this in mind, LGIM launched an engagement-led strategy in 2023 focusing on companies that traditional net-zero strategies would tilt away from. "It is focused on the subset of companies where we can identify that they are currently climate laggards but have the potential to become leaders and unlock shareholder value in the process. A detailed, pro-active engagement programme with very specific actions and KPIs aims to move them along that journey over time," Brown adds.

**I'd like to think that a theme in 2024 will be a focus on what is meaningful, rather than what is accurate.**

Tim Manuel, Aon

### New disclosures

The disclosure regime will also be a big part of investment conversations in 2024, believes Nico Aspinall, a sustainability advocate at Newton Investment Management.

The final rules of the Sustainability Disclosure Requirements (SDR) were confirmed in November and will have a big impact on sustainable strategies. "We will spend a lot of next year working out which products will meet those rules and presumably creating new ones," he says. "That for me is huge.

"We are supportive of the SDR regime as it aligns with many things we do and how we think about sustainability.

"How investment management firms think about ESG is pretty foundational, so that could start to move things around next year," Aspinall adds.

SDR is not the only reporting disclosure that investment managers will need to get to grips with in the coming year. The Carbon Border Adjustment Mechanism will be implemented in the EU in 2026, but its reporting phase comes into force from January 2024 targeting iron, steel, aluminum, fertilisers, electricity, cement and hydrogen imported into the bloc.

The mechanism is being introduced to "prevent carbon leakage from their own carbon standards", says Abbie Llewellyn-Waters, an investment manager for global sustainable equities at Jupiter Asset Management.

"So at the point of importation, the carbon content of the product sold within those initial seven categories will now be initially measured, [and] ultimately priced," she adds.

The international response to this initiative has been expedited with several carbon-based initiatives being developed.

The US, for example, has initially responded with The Prove It Act – provide reliable objective verifiable emissions intensity targets – which requires the Department of Energy to study and compare the emissions of carbon-intensive sectors.

Other global mechanisms have developed, notably in China and Australia; with the former developing a carbon footprint management system for 50 products by 2025, introducing national level accounting rules. The UK is also working on its own version. "So it is logical to assume that over the next two to three years, we will have established mechanisms that internalise the price of carbon on a direct basis," Llewellyn-Waters says.

"From our perspective, what we look to in our capital allocation process, is those companies that are well positioned for when markets better reflect the climate-related financial risk and ultimately the valuation of the companies that we are investing in," she adds.

Those companies, Jupiter believes, are ready for this transition, in that they can "respond to those regulatory developments", which gives them a competitive advantage.

Llewellyn-Waters uses cement as an example. "If you want a tonne of cement, and you receive two quotes of the same quality that can be delivered on the day you want it, then you are probably going to go with the cheaper option.

"Companies with less carbon to price in their products therefore have a competitive advantage," she says.

"For us, companies who understand the direction of travel and have sought to decarbonise their businesses to prepare for a low-carbon transition are much better positioned than those who have not."

So Llewellyn-Waters believes that this mechanism has the potential to make "a significant difference" in the transition to a 1.5-degree climate scenario.

"And the mechanisms that will come into force, will accelerate internalisation of climate-related financial risks, with the valuation of equities better reflecting their transition strategy," she adds.

### Rage against the machine

But the new year could see a pushback against the rules. "I'm going to call it a rebellion against regulation," says Tim Manuel, Aon's head of responsible investment.

A raft of ESG-related regulation has been introduced in the past few years emphasizing policy, process and disclosure. In short, it requires investors to collect more data to prove they have considered the environmental risks of their investments.

"It has done a great job of putting climate on the agenda and getting the issue firmly in the minds of investors," Manuel says. "But the issue is that regulation hasn't created an impetus for action.

"Many investors have recognised the importance of the issue, and they want to do something about it, but their resources are being drained by what regulation is continuingly asking them to do, which is more disclosure, more data.

"That is taking energy and attention away from what investors know they need to do, which is to start investing differently," he adds.

So Manuel expects to see some pushback here. It could start with the consultation looking at what the Sustainable Finance Disclosure Regulation should look like in future, which some are questioning if we should rip it up and start again. "I wouldn't be surprised if there is a high degree of support for that," he says.

"At the end of the day, change is not going to happen on the basis of nice disclosures. It is going to happen if people start behaving and investing differently."

The regulatory focus on transparency is making some people too cautious about the accuracy of the data they are disclosing, Manuel believes, which is acting like a barrier to action. There are instances, he says, where it is doing more harm than good.

"In most cases, we are going to be judged on action at the end of the day, not glossy disclosures. So I'd like to think that a theme in 2024 will be a focus on what is meaningful, rather than what is accurate," Manuel says.

### Plain speaking

ESG has dominated investment conversations for many years, but if you asked five people what it means, you could receive five different answers. Indeed, an asset owner once told me that ESG is "three random letters that have been thrown together which we have to work with".

Such confusion could cause problems. "ESG is a term that has been prodded and twisted out of shape over the past year or two," Manuel says. "If ESG as a label is not used well it could cause more confusion than clarity.

"It is important for people operating in this space to be more conscious about language, to speak accurately and precisely about what they are trying to achieve.

"Sometimes ESG is used out of laziness: 'I know there is something that I should be talking about, but I'm just going to substitute it with "ESG" and hope that the person who is listening understands what I mean'," Manuel says.

**We hope there will be more action on methane next year.**

Peter Mennie, Manulife Investment Management

> **Regulation hasn't created an impetus for action.**
>
> Tim Manuel, Aon

He uses water as an example. It is a finite natural resource that supports life on Earth and which all businesses need a clean, constant and secure supply of. Semi-conductor makers, for example, are massive consumers of water. So not only is it a sustainability issue, but it is a financial risk for investors.

"Why not just talk about water being a business risk and an investment risk, rather than about it being an ESG risk," Manuel says. "There is often no need to label things as ESG. Using the term in a lazy way can sow confusion.

"A trend will be everyone starting to talk more precisely about what they mean in this space," he adds.

### 30 by 30

Biodiversity has become part of investment conversations for a couple of years now, and in 2024 the theme will continue to evolve, says Peter Mennie, chief sustainable investment officer of public markets at Manulife Investment Management.

"It has been a year since we were in chilly Montreal for COP15," he adds. "One of the key outcomes from that was the 30 by 30 target, which gives us evidence of where public policy is going and the angle we need to take when engaging with companies to promote nature-positive action."

In the year ahead, Mennie expects the 30 by 30 target to be a priority that drives decision-making on engagement targets alongside Nature Action 100 and the PRI's Spring initiative.

"When we talk to asset owners, they are thinking about their dependencies and impacts on nature," he adds. "So we are expecting to see an increase in reporting on nature."

So 2024 is the year that will see asset owners beginning to work towards putting that into practice, says Eric Nietsch, head of sustainable investing for Asia at Manulife Investment Management. "There are other pieces of regulation and pledges that are being made, which will come up next year at COP16, which is the first time that countries will begin to show their progress."

He adds that there are things happening on the regulatory side in Malaysia, the Philippines, Indonesia and Vietnam, while changes in Europe will also have an effect on Asia, specifically the EU Deforestation Regulation. "It comes into effect at the end of 2024 and covers supply chains, so that any product that goes on a shelf in Europe will have to show that it has not contributed to deforestation.

"Palm oil, for example, has been heavily scrutinised," Nietsch says. "Deforestation related to palm oil has decreased by about 80% over the last 10 years, but this new regulation will also cover rubber, coffee, cocoa cattle, wood and soy.

"We expect a lot of companies to be working on that through their supply chain next year," he adds. "If everything has to be clear by the end of December, then that means they have to do the work in 2024. That is just another example of regulation off the back of COP15."

Mennie says that nature and biodiversity should matter to everyone. A third of the world's medicine comes from nature, a third of our food supply is dependent on pollinators and with studies showing the potential job creation linked to addressing biodiversity loss, this is something we should all care about. As we move towards COP16 we are expecting to see a real focus on how we address it.

"The 30 by 30 target provides a framework and focal point for everyone to work towards: but we need to make sure it works and we need to harness the power of the markets and set the right incentives to make sure that targets are met," he adds.

### Moving out of the shadows

It is becoming widely understood that climate change and biodiversity are linked. "If we just build an economy that doesn't emit carbon dioxide, there is a big risk that we will still destroy the planet," Newton's Aspinall warns. "Indeed, a good way to absorb carbon dioxide is to maintain our forests and oceans.

"Biodiversity has become a topic on its own," he adds. "The Taskforce on Nature-related Financial Disclosures is fresh out and clients are namechecking it more and more, so there is definitely an increasing client awareness of the topic."

Aspinall expects more and more of Newton's clients to be discussing natural capital going forward, as they try to understand how this systemic risk might affect returns.

"More of the investment process will be dedicated to natural capital as more and more people are thinking about these risks and more data is becoming available," he says.

Aspinall explains that when it comes to biodiversity, the investment world is not at the same stage as it is with climate change, but collectively responsible investment teams are pushing that agenda and there could soon be change. "In 2024, we could see positive change in internal philosophies around biodiversity," he says.

### Natural risks

Many of the trustees Manuel speaks with are more engaged with nature risk than climate. "You can't take the person out of the decision-maker," he says. "People are more deeply affected at a personal level by issues connected with nature than they are with issues connected with the climate."

You look up at the sky and know there are emissions up there because scientists tell you that they are, but you can't see them. The destruction and abuse of the natural world is more tangible and visceral. "There is a personal drive that sits behind the decision-maker to want to do something about it, because there is something they can do."

The development in biodiversity during 2024 will be, Manuel believes, the realisation that if you think climate is complicated, then nature is a whole another level. "Not least because with climate there is a generality to it," he says. "Rising temperatures are a huge global problem, there is a similarity about it everywhere. The same solutions are going to solve that problem.

**In 2024, we could see positive change in internal philosophies around biodiversity.**

Nico Aspinall, Newton Investment Management

"But nature is location specific," Manuel adds. "The nature issue in the UK is completely different than the nature issue in the Amazon, which is completely different to the nature issue in Southeast Asia. And the solutions to those issues are different, too."

### Evolving frameworks

Nature risk is also a hot topic for LGIM. "Over the last few months, we have received a big increase in questions about what it all means for investors," Brown says, who puts a lot of this down to The Taskforce on Nature-related Financial Disclosures (TNFD) coming onto the agenda for institutions.

"It's not an obligation, but having experienced TCFD, I guess people would like to get ahead of the game," she adds.

To helps its clients get ahead of the game, LGIM has been adapting its ESG scoring frameworks to incorporate nature-related metrics and are looking at strategies in this space, such as, for example, debt-for-nature swaps where it has experienced a jump in enquiries.

Biodiversity has a connection to climate change and so the firm is making sure that strategies evolve to account for nature risks. "I expect to see more and more interesting discussions on that side of things," Brown says.

To include it in their frameworks, LGIM have broken the issue down into its underlying component parts. Deforestation and water management are the two areas they have decided to start with, given that there is data available. "I would expect to see more and more in that space as more data is available," Brown says.

### All that gas

Finally, governments are working to achieve the Paris agreement through investing in renewables and scaling up decarbonisation technologies, but there are other issues they need to tackle.

"We hope there will be more action on methane next year," Mennie says. "There seems to be an increasing alignment on action on methane and potentially more countries joining the Global Methane Pledge."

Methane is a potent greenhouse gas, which has a warming potential 84 to 87 times that of Co2 over a 20-year period. The IEA identifies cutting levels of this gas as a crucial part of hitting the 1.5-degree target.

"The next 20 years are a critical time for addressing climate change," Nietsch says. "Watching what happens out of the next COP will be interesting."

COP will certainly influence institutional investment portfolios in the coming year, with making a positive impact on the natural world and fighting climate change high on the agenda in what promises to be a year where ESG continues to evolve.

pi ESG CLUB CONFERENCE

# DRIVING CHANGE IN CHALLENGING TIMES

## ESG Club Conference 2023

Following our review of the energy transition and natural capital discussions in our November edition, the second and final part of *portfolio institutional's* ESG Club Conference coverage looks at how institutional investors can make positive social impacts.

Promoting greater equality and innovation within healthcare as well as providing access to adequate housing are just as important as protecting the natural world when working to build a sustainable future.

We also review a discussion on the quality of non-financial data and how investors can overcome inconsistences in corporate reporting to make better decisions.

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# ESG CLUB CONFERENCE:
# ESG RATINGS – WHAT'S THE SCORE?

Non-financial disclosures are inconsistent, making it difficult to build an accurate ESG profile of assets. Rating providers claim they can bring clarity, but rarely reach the same conclusion on individual companies. Is this because there are too many factors to consider or are these ratings simply not fit for purpose?

ESG scores are one of the most debated topics within the sustainable investment arena. The issues surrounding the topic were central to the third session of *portfolio institutional's* ESG Club Conference, appropriately titled: *ESG ratings – What's the score?*

Starting the discussion, MSCI's Elchin Mammadov said that investors using MSCI's ESG scores fall into one of two "investor buckets". The first is traditional investing, where the focus is on maximising returns. Here ESG data is used with their financial analysis to help identify risk within a company's valuation, profitability and competitive position.

The second bucket is a smaller and more diverse group of investors who analyse the impact assets have on society and the environment. "They avoid companies which are making a negative impact to focus on those generating a positive impact," Mammadov said.

There is also a methodology that uses a mixture of the two approaches. "This is what we call double materiality, where investors think about maximising their risk-adjusted returns, but also try to avoid companies that do not make a positive impact," Mammadov said.

### Buyer beware

Addressing the criticism voiced by some investors that ESG scores are often too simplistic to be useful, the PLSA's Joe Dabrowski said: "There is a lot of tension between what pension schemes need in practice and what is in the underlying data."

He also noted that trustees are reliant on advisers and consultants to interpret the data, for which there are different needs across the pensions sector based on issues such as the size of the scheme. "As a trustee you are looking for information that you can trust and readily use, as well as being reliable and comparable. But in the ratings space, we don't have that," Dabrowski said.

"It is emerging but is a bit of a buyer beware situation presently."

This poses obvious challenges for investors, especially pension funds, when addressing the ratings situation.

Dabrowski was keen to qualify his thoughts that investors, including pension funds, do have accessible data, but he stressed a more fundamental point. "How robust it is? How comparable it is?" he said.

Questions also surround ratings being unregulated, as well as issues concerning governance and system controls. "Investors are in a slightly difficult space," Dabrowski added. "It is a real pickle at the moment, and we need to resolve all of that."

### Are you serious?

Moving the discussion on, Shai Hill, chief executive of data provider Integrum ESG, tackled the issue of whether investors can take ratings seriously when there is such divergence among providers.

First, he questioned if there is, in fact, a big divergence. "I suppose the answer is, yes." Hill cited research from the Massachusetts Institute of Technology, which compared the ratings of ESG providers and concluded that they are more likely to disagree than agree on a score. Hardly a reliable starting point for investors. "That does lead to a lot of frustration," he added.

Hill then started unpicking some of the flawed perceptions about ESG scoring. "People want ESG ratings to be like credit ratings," he said. "In my view, that is a foolish expectation, because it took decades to reach a consensus of what makes credit worthiness."

In comparison, Hill said, ESG is an enormous range of topics, from the composition of the remuneration committee to the amount of air pollutants emitted per annum.

He, therefore, suggested that investors should not be frustrated, as ESG is too wide ranging to be boxed into a single score.

### Material world

That said, there is, he highlighted, a consensus on what the material issues are for a company based on its sector, but not how material those different issues are. "And what affects ratings is the weighting you put on something," Hill added.

"The balance between quantitative and qualitative: how you measure that is a huge issue. Do you reward a company for having a strong [ESG] policy, or do you ignore it?"

Hill's central point being the logic behind ESG scoring is never clear. "Why are asset owners and trustees relying on ratings they cannot understand?" he asked.

Then the other Hill on the panel, Mark Hill from The Pensions Regulator, highlighted the importance of effective ESG scores. "The credibility of ESG ratings has a role to play for corporate disclosures to be effective," he said. "So we are looking at that credibility for them to be useful.

"As a regulator, we are very much aware of all this and is why we are looking at how to increase that coverage and credibility," he added.

As a result, The Pensions Regulator is undergoing a major regulatory initiative which looks at the statement of investment principles and the implementation statements. "What we are doing is looking at ESG and climate-related disclosures in relation to the financial and non-financial considerations. Hopefully, the results of that will be published in early 2024," Mark Hill said.

"That will hopefully help drive that expansion and credibility," he added. "The integrity of disclosures is very important."

### Private problem

When it comes to corporate bonds and listed equities, the climate-related data is pretty good, Mark Hill said, but he added that private markets are a challenge. "From a regulatory perspective, we want to see an improvement in invested data and disclosures made available to trustees, service providers, investment managers and advisers in order to give them a better understanding of the risks and opportunities and how to manage that," Hill said. So how can the industry improve the quality of non-corporate disclosures? "There is a lot we can do for ourselves," Dabrowski said.

Thinking about what can and is being done as an industry, he cited: guidance on the issue of disclosure, shared experiences, looking at implementation statements, case study work, engagement with the regulators, setting out the industry's stewardship expectations and uniformly pushing those as hard as possible.

Dabrowski, therefore, put a strong emphasis on investors, like pension funds, playing their part. "That will be driven by getting amongst ourselves some form of consensus on what matters to us. You hear a lot on that about corporate disclosure, or disclosure from asset managers," Dabrowski added.

But putting the issue into context, he said that climate-change reporting has taken an "incredibly long time" to be part of corporate reports. "You need in some cases the hard rod of legislation to hold people to account."

Nevertheless, there are discussions taking place about ratings, which left Dabrowski reasonably optimistic that it will feed through to benefit investors. "We need to be able to use all of that at any level of [pension] scheme," he added.

### An alternative view

Returning to the scoring methodology, dealing with the challenges in MSCI profiling a company and setting an accurate score, Mammadov admitted: "It's not easy."

But he added that the way MSCI approaches ratings is through collecting a great deal of data. "We take time standardising and structuring that data. We have over 400 analysts doing that," Mammadov said.

"But the issue we have is a lot of data reported by companies, whether voluntary or mandatory, is not standardised, it is cherry picked," he added.

MSCI, therefore, utilises alternative data sources, which includes regulatory data, such as has a company had any recalls or fines, as well as data from non-governmental organisations like the World Bank. "More than a third of our ratings are derived from using that third-party data," Mammadov said.

He added that there is always a methodology behind everything MSCI does. "The way we think about the ratings is: what risks and opportunities is the company exposed to? And what is the company doing in managing those risks?" Mammadov said.

He added that MSCI focuses on six to eight financially material risks for a company, with a weighting for each one of them. "A lot of our clients are smart and don't take the ratings at face value. What they tend to use is the underlying data. Then they can adjust the weight of the rating on the key issues they think are relevant," Mammadov said.

Shai Hill added that materiality is important. "If you have a tight materiality framework you are looking at the seven things that are material for that company," he said.

### Mind the gaps

But what is evident is that there are big gaps in the available data. So how can these be filled? For Shai Hill, it comes back to there being transparency issues in the data. Although, he added: "We have a phrase which is: no disclosure is valuable data. As in, don't try to fill it with some type of estimate or proxy. Estimates are dangerous."

And he wondered if asset owners know how much estimated data they are using. "It is a real concern, one the regulator should be concerned about," Hill said.

Offered to come back on this, Mark Hill from TPR, retorted: "Where do you start?" He noted there is an issue of the professionalisation of trustees, in that they need to have the right tools to look at such issues and say: "That doesn't look right."

Comparing matters on a geographical basis, how do corporate disclosures in the UK versus the US and emerging markets shape up? "Europe is leading the way globally in terms of disclosures on ESG and climate," Mammadov said.

However, he also said it depends on if you are in developed or emerging markets, with disclosure better in the former.

"Compared to Europe – the US, China and Canada lag," he added. "In China there is an ESG standard, but it is voluntary. And in the US, SEC proposals are still not final."

#### Different strokes

Although there can be regional differences on different types of disclosure. "In the US there is good disclosure on governance and business ethics. In other parts of the world there is better disclosure on diversity, but in some markets it is illegal to report that data," Mammadov added.

The good news is that many emerging markets are looking to adopt frameworks like the Task Force on Climate-related Financial Disclosures (TCFD), which could go a long way in helping to standardise reporting globally.

So how far are we from having a compulsory framework on disclosure? "It is fair to say it is a while off," Mark Hill said.

Joe Dabrowski
Deputy director
Pensions and Lifetime Savings Association

Mark Hill
Climate & sustainability – business lead
The Pensions Regulator

Shai Hill
CEO
Integrum ESG

Elchin Mammadov
EMEA co-head of ESG and climate research
MSCI

But there are positives. He listed a number of initiatives that have paved the way for a possible all-embracing disclosure framework. "The then chancellor in 2021 talked about a disclosure requirement regime, which was reiterated in a revamp of the green finance strategy in March, so the direction of travel in that regard has been set," he said.

Mark Hill then added: "We have TCFD forming the framework, the Taskforce on Nature-related Financial Disclosures is based on the foundations of TCFD, we also have the Transition Plan Taskforce soon releasing its framework and sector specific guidance due out in early 2024, which includes asset owners and asset managers. We also have the green taxonomy for the UK. "The building blocks are most definitely there to deliver it."

Mark Hill continued to note other matters that could get in the way – at least in the immediate future. "We have an election coming up, so I don't think we are going to see anything before 2025 in terms of an integrated, holistic and sustainable disclosure requirement regime."

## ESG CLUB CONFERENCE:

# THE BIG S: MAKING A SOCIAL IMPACT

Using institutional capital to build a better world is not just about cutting harmful gas emissions and improving access to fresh water. It also involves tackling social challenges, such as providing adequate housing, education and healthcare. The final panel of our ESG Club Conference looked at how institutional investors are using their capital to reduce inequality.

"Most investment impact is not achieved through impact investing," said Dan Neale of the Church Commissioners for England as he opened the discussion.

"Most of us can't be impact-first investors, we can't take concessionary returns," he added, explaining that when people talk about making an impact, they usually mean that "some positive stuff happens" in their investments where the potential return was the main driver for investing.

As proof, he pointed to less than 1% of assets under management globally are allocated to making an impact, based on The Global Impact Investing Network's claim that the market is worth $1.1trn (£900bn). The main problem is that it is harder to make a positive social impact than a positive environmental outcome, where an investment causing less harm to the climate is acceptable. "You can't have that equal narrative with social," Neale said. "With social we can't say this is an investment with less slaves. It doesn't have that same ring as having less harm on the environment."

Another issue with the social pilar of ESG is the lack of offsets. "You can't say that the good we are doing over here makes up for the bad over here," Neale said. "There are positive impacts and there are negative impacts with every investment, but they do not exist on a balanced scale."

However, Abbie Llewellyn-Waters, who is responsible for global sustainable equities at Jupiter Asset Management, disagrees with Neale, believing that it is not mutually exclusive to have a capital growth objective and a positive impact. "The two can co-exist comfortably. It is not one or the other," she added.

### Social mobility

One "exciting" capital growth opportunity and positive social impact multiplier Jupiter is looking at is financial inclusion.

"There are 1 billion unbanked adults in the global economy, so investing in companies that enable the digitalisation of cashflow is an important step forward for inclusive economic growth," Llewellyn-Waters said.

This means investing in digital payment operators, payment networks or digitalisation-enabling software. "It is important, particularly for communities in rural or remote regions where they don't have the infrastructure to facilitate economic inclusion from a financial service provision perspective. That is an exciting aspect that we can look at," she added.

Another social mobility enhancer in Jupiter's portfolio is a company that makes cochlear implants, which synthetically recreate the neural pathways between the brain and the ear.

"The congenital deafness run-rate for babies is one in 1,000 in the developed world. It runs about one in 250 in some other regions," Llewellyn-Waters said.

"The economic isolation of deafness can be detrimental to the child," she added. "Treatment for the first two years of life leads to almost 100% inclusive economic trajectory for that child."

Then there is Valspar, a US social mobility enabling paint manufacturer. When a sole trader comes into one of their retail outlets, they facilitate full invoicing to enable them to operate on a company basis, allowing for decent work and economic growth "yet they are selling paint", Llewellyn-Waters said.

"So it is an interesting way of looking at the effect your capital allocation process and the impact multiplier can have on the economy," she added.

## The four Cs

But how easy is it to make a social impact through investing in real assets. In the past 15 years, Legal & General Investment Management (LGIM) has invested more than £30bn in assets such as transport, schools, commercial buildings and housing.

"For us, it is about improving asset value and performance, and that goes hand in hand with positive social and environmental outcomes," LGIM's Shuen Chan said.

There are many reasons why making a social impact is important to LGIM, but there is one fundamental driver. "The infrastructure investments we make and the assets we develop, manage and operate are ultimately for people and communities. Without them, our business model does not work," Chan said.

So LGIM is focused on making place-based impacts. "What we ask ourselves is, how can we as real asset investors contribute, deliver and catalyse change for the communities where our assets are based," she added.

This approach is underpinned by what Chan called the four Cs. The first is the community where the asset is based. "The social challenges facing a coastal town such as Poole in southeast England are different from the challenges faced in Maryland in the US, for example."

Then there is commercial. "There doesn't need to be a trade-off between driving positive outcomes and commercial returns," Chan said. "There is a proven relationship between real assets, building resilient economies and investment returns."

The third C is collaboration: identifying strategic partnerships that help you understand the needs of the local community. Finally, there is being catalytic, in that when you understand how you can drive change, you drive it at scale.

## Investing with purpose

Agreeing with Chan that it is possible to earn a return from making a difference to the lives of the most underserved in society, was Anita Bhatia, investment director of the Guy's and St Thomas' Foundation.

The foundation's purpose is to address health inequality. Bhatia and her team approach this by looking at countries which do not have a public health system. "So how do we make investments, direct or indirectly, that can deliver accessible, affordable healthcare to vulnerable people whose needs are not being met?"

But this is not just about access to healthcare. Other themes that are connected to this include what impact is climate changing having on vulnerable populations.

"There is more volatility in the weather, more floods, more heat waves," she said. "And they affect the poorest in society, the people that either end up with severe health conditions or even death. So, how can we make investments using climate as a sleeve in order to be inclusive?"

Bhatia then moved into diversity, equity and inclusion. "One of the trends I'm seeing is the supply of investment opportunities," she said. This typically means litigation funds, which are trying to address social and racial injustice. "[This] is an exciting space if you are investors in private markets.

"What I would say is, focus on your objective, spell it out and then embed it into your investment strategy with either an impact thesis or a theory of change," Bhatia added.

## Respect and protect

Setting high standards of human rights is a big part of reducing inequality, but "ensuring" the protection of those rights could be difficult for investors. "Words are to social what numbers are to climate," Neale said. "Ensuring is a tricky word. As soon as you get outside of your own business, it is hard to ensure anything. You can require stuff in your contracts, but then you go into another tier and another tier, and it gets harder and harder.

"Governments have a duty to protect and enable human rights," he added. "Businesses have a responsibility to respect human rights, which means they need to identify where they are linked to such risks. They then need to take action to avoid, mitigate and, if necessary, provide access to remedy for those."

Frameworks such as the UN Guiding Principles set out how you could do that. "But the problem with the supply chain stuff, is that it is an exponential problem," Neale said.

Supply chains are not like little links in a neat line, he explained, but more like a network where each link splits into different tiers. The chances, therefore, of identifying and mitigating against human rights abuses are quite small without having strong systems.

"If your supplier is a tier one family-run farm in Hampshire, you probably have a good chance of being able to use your leverage to figure out and address what the risks are," he said. "If it is tier six in China, you are going to be limited in what you can do. It is not easy."

To improve the chances of success, Llewellyn-Waters recommends that investors commit to the UN Global Compact, which has principles on issues including human rights. "This is forced labour, modern slavery and child labour," she added. "This is the base-level standard of what should be acceptable for companies operating on a global basis."

Another way to improve social mobility in supply chains is to encourage the living wage. Llewellyn-Waters used the example of Unilever, which wants all their tier one suppliers to pay a living wage to their employees by 2030 or find another client. "The social impact multiplier of that is huge," she said. "We are talking about some of the most vulnerable manufacturing and agricultural workers in Brazil, China, India, Indonesia, Vietnam and the Philippines."

### The right structure

Equity gives investors influence over companies, but it is a different story with debt, where lenders do not get a vote.

LGIM are long-term debt investors, typically lending between 10 and 25 years. "That long-term element allows us to build relationships and engage with the borrowers," Chan said. "But as lenders there is only so much we can influence once we have invested.

"So it is important that we take into consideration environmental and, in this case, social factors in the pre-investment stage," she added.

One example is housing. With many of the world's homes expected to still be inhabited in 2050, there is a huge retrofit challenge to decarbonise that stock. LGIM has invested more than £300m in social and affordable housing and linked the loans to the borrower's decarbonisation objectives.

"This not only meets low-carbon economy objectives, but also addresses fuel poverty, because high energy bills are a fundamental challenge that the affordable housing sector faces," Chan said.

### Community engagement

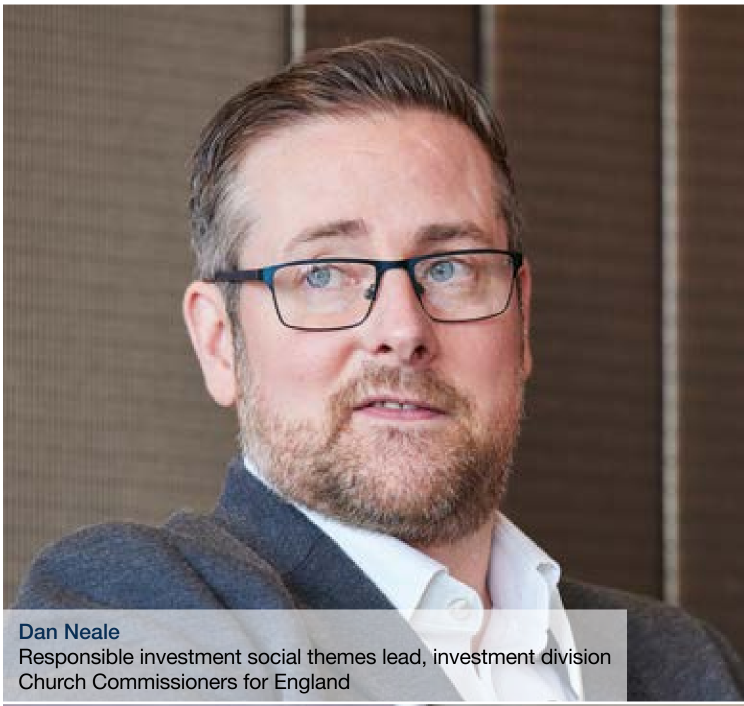
Measuring the impact of your investments is not easy. LGIM has created a place-based impact framework around the core pillars of inclusive economy, quality of life and climate and nature. Beneath that are the key performance indicators.

"Impact, especially social impact, means different things to different people," Chan said. "Although measurement is important and a rigorous and consistent approach is critical, I want to stress that when it comes to social impact, measuring someone's quality of life should not be distilled into a number or monetary value.

"This is why we approach it by understanding what the needs are for the community based on where the asset is," she added. An example of this is that LGIM owns a shopping centre in Poole, which is connected to a high street that Chan described as "dated and unloved". "The first thing we did was provide free rates for two years for the local businesses on the high street.

"That not only created jobs but generated over £2m of revenue for the shopping centre. That comes back to the commercial element."

On community and collaboration, LGIM has developed and nurtured organisations to tackle serious local social and environmental challenges, including homelessness and patient waiting times. One example is its partnership with the NHS by building a diagnostic centre in the shopping centre. "As a result, it has driven footfall and, therefore, rental income,"



**Dan Neale**
Responsible investment social themes lead, investment division
Church Commissioners for England

**Shuen Chan**
Head of responsible investment & sustainability
LGIM Real Assets

Anita Bhatia
Investment director
Guy's and St Thomas' Foundation

Abbie Llewellyn-Waters
Investment manager, global sustainable equities
Jupiter Asset Management

Chan said. "It has treated 4,000 to 5,000 people for ailments such as cataract and screening for breast cancer. It has basically driven commercial returns for us.

"This is one of many examples where we are thinking about the needs of the community and engaging with them."

## Leaving no one behind

There is a social aspect to the energy transition in the desire to leave no one behind as new processes emerge.

"People are at the heart of [a just transition]," Neale said. "You have the workers, the community around the workers, the longtail supply chain and the consumers of those products. These stakeholders are what investors should be thinking about when they are looking at those companies.

"We don't want to repeat the 70s and 80s with lots of redundancies, where people are left unskilled and the social unrest that comes with that," he added. "We don't want hollowed out communities and we don't want contagion in the supply chain."

What is needed is decent standards of green jobs coming through, supply chains that don't use forced or child labour and affordable energy. "The problem is that green does not always equal good. There are social risks that go with that, but they are part of the transition that needs to be sorted," Neale said.

## Representation

Other societal tailwinds include what Jupiter calls preventative healthcare. This is where companies support early detection of disease, which usually leads to better patient outcome and lower healthcare costs.

"We like that as a structural tailwind," Llewellyn-Waters said. This means investing in vaccine manufacturers, diagnostics, microscopes, heart rate monitors and optical scanner makers. "We like that because there is less regulatory risk from a pricing perspective and also the outcomes are typically more positive in the preventative aspects," she added.

It has, for instance, a company in its portfolio that enables 6 billion diagnostic tests each year for the early detection of cancer. "That is a huge social impact multiplier through that product aspect there," Llewellyn-Waters said. "We like those types of companies."

The narrative for female participation has for a long time been about representation at senior level, but Llewellyn-Waters believes that we need to "go a bit deeper into the workforce characteristics".

She pointed to reports from the IMF and World Bank on the trillions of dollars that could be added to the global economy if there were more women on the global workplace. "This feels like an easy, tangible, quantifiable analysis set for us," she added.

One such company in Jupiter's portfolio is an Australian biotech, where half of its employees working to improve the efficacy of vaccines are women.

Llewellyn-Waters closed our conference with a thought that investors should have a greater understanding of the makeup of the companies they invest in "and what that can do on a global inclusive growth participation basis".

"That is also something that you could ask your managers to look at on a portfolio aggregate level: what is the female participation rate of the companies that you invest in?"

# DISCUSSION: FIXED INCOME

After a difficult period, yields have climbed to levels that have made bonds more competitive with other asset classes. Yet this is also a period of low economic growth in the developed world and growing geopolitical uncertainty, especially as 2024 will see elections on both sides of the Atlantic. *Portfolio institutional* sat down with asset owners and those making investment decisions on their behalf to find out how they are navigating these markets.

**How have asset owners adjusted their fixed income portfolios during such an aggressive rate-hiking cycle?**

**Umer Nazir:** We have seen fixed income return to the fore as a result of this rate hiking cycle. The asset class is offering attractive yield and income for the first time in years. Investment grade credit yields are now roughly in the 4% to 6% range, which is what high yield was offering 18 months ago. As a result, we have seen higher flows into higher quality asset classes – our investment-grade fund has nearly tripled over the last eighteen months, which is a function of where yields are.

On the other hand, what has surprised me is the incremental addition to risk asset classes. This includes our multi-asset credit fund, which has high yield and emerging market debt exposure.

**Callum Logan:** The interest rate point is critical. The risk-free rate is meaningfully larger and, therefore, you are getting rewarded in the fixed income space.

We are seeing attractive opportunities for a diversified growth portfolio that we did not see previously. Prior to Covid we exited high-yield debt and other higher risk public fixed-income assets. But we now see those areas as being able to compete for capital with public equities, real estate and infrastructure, which have not seen yields rise to the same extent.

Another area we are interested in is securitised assets, which are often short dated and floating, so have been less affected from a duration perspective by the sharp rise in rates.

**Nicolas Forest:** We are in a new regime in terms of inflation, which is a big change for the fixed income markets. We have seen a dramatic increase in real yields over the past few months, to levels we have not seen for 10 years.

We are also at the end of the monetary cycle. Looking at history, after the last hike there is normally a bond rally of between 60bps and 100bps. This is because there is an opportunity to invest in bonds with longer maturities, especially investment grade.

For me, the big change is that we are at the end of high inflation and close to the end of the tightening cycle. That is a big change for fund managers. Comparing debt and equity for the coming year, US government debt, for example, has the same level of expected return as US equities. Because of the carry, even if we hedge the currencies, we have a reasonable expected return close to 8% from US bonds.

So bonds are back. We are in a new regime where fixed income expected returns have become much more attractive than equity on a risk-adjusted return basis.

**Adam, what is your outlook for investment grade and high-yield debt?**

**Adam Darling:** I am surprised at how sentiment towards fixed income has not improved. In 2020, yields were -2% in sterling investment grade. They have only moved one way since, thanks to interest rates going up and credit spreads selling off. The cash yield is now 6% but our fund is 7%.

And if we are coming to the end of the interest rate cycle and the inflationary paradigm, even if it falls to 2.5% or 3%, on a risk-adjusted basis, it just looks attractive.

High yield is a lot more nuanced. It has had a far better year than I would have thought because credit spreads are not pricing in a recession. If you did not have any other piece of information, the history of credit spreads would say that the high-yield market is predicting a soft landing.

My view is that is not going happen. If interest rates do not fall from where they are today, households and governments have to refinance into that and we could get a nasty landing.

We are in an environment where you can be pretty bullish on investment grade, while high yield is going to be much more about selective active management.

**Kate Hollis:** Our clients look at fixed income through two buckets. There is the liability matching piece and then there is return seeking.

We have seen two themes in the return seeking piece this year. The first was that people wanted more liquidity, even outside the liability matching portfolio, as central banks raised the level of collateral necessary for liability-driven investment (LDI) portfolios.

The second theme is that a lot of our defined benefit (DB) clients are moving towards buyout. While that precludes them from private equity, real assets and long-duration illiquids, they are selectively interested in private debt. Maybe they are looking to buyout in 10 or 15 years and some private debt is expected to mature in five to seven years. If you pick it carefully, there are good opportunities in private debt at some good yields.

**Gerald, how are your DB and defined contribution (DC) schemes using fixed income?**

**Gerald Wellesley:** The big focus for DC is decumulation, which has been an unloved sector because the assets have not been there. But with fixed income yielding what it does now, one can structure secure income-generating strategies that perhaps could yield 5%-plus when 3% to 4% was the mode before.

On the DB side, the big scramble now is to buy bonds. Buy and maintain is popu-

> Chinese bonds are becoming less attractive, especially compared to US bonds.

Nicolas Forest
Chief investment officer
Candriam

lar and I have a mature scheme where it will pay the payroll on a gradually maturing basis. On top of that is multi-asset credit, which is now yielding 8% or more. What is not like to like about that if the required return on the assets is 5%, which seemed unachievable years ago.

**What role does fixed income play in your portfolios, Callum?**

**Logan:** Our schemes are growth focused, but we have a small allocation to lower risk assets, such as gilts and cash, to call on if we need to avoid being a forced seller of our growth assets.

They clearly offer a lower expected return although higher than previously. In the growth portfolio, fixed income has become more interesting. There was no place for some of these fixed income mandates in recent years because they could not compete with equities and real estate, whereas now they can.

We are seeing much more interest in private debt, but we are careful in how we approach that because some of these companies have too much debt and are vulnerable from rises in interest rates.

The public side is where we have been making the biggest changes. Emerging market debt is an area of interest, as you are going to get a bit more yield.

Emerging markets are further on in the rate cycle and are beginning to cut rates. They have historically been the ones suffering from high inflation, but in recent years we are seeing that in developed markets. Brazil is a good example where they hiked early and are now in a stronger position.

**Is the rising cost of debt stifling green bond issuance?**

**Forest:** Issuance of green bonds is significantly below expectations, but this is the case for many credit segments.

When you say the high-yield market has been resilient, the main reasons have been the technicals. We expected a huge level of issuance for high yield and investment-grade green bonds, but it didn't happen.

**Will green bond issuance improve in 2024?**

**Forest:** It will depend on the evolution of the European Green Bond Standard and the appetite for issuers to come with green bonds. The point is there is less incentive for issuers to come with green bonds today. We are expecting more clarification about the framework and are monitoring it closely.

**When will inflation hit the Bank of England's 2% target?**

**Darling:** Are we going to be at 2% next year? I don't know, but it will be a lot lower than it is today.

From a psychology perspective, it doesn't have to get back to 2% for people to lose their panic about inflation. If the UK is at 3.5% or 4% by the end of the year, we are coming from double digit at the start of 2023 so people will not feel that they are in an inflationary paradigm so much. You will see cooling pressures and things like wage negotiations, you will see companies pricing inflation risk differently from what they planned for their budgets, capex and their employment schemes.

We are going to be in a more normal world next year. It might not be 2%, it might be 2.5%, it might be 3.5%, but the psychology could change quickly. A lot of that will be due to what's happened with money supply, monetary discipline and the end of the fiscal splurging that we had after Covid.

**Hollis:** Back in the late 90s, equity allocations in some UK pension funds were more than 90%. But as schemes progress to run-off, they need more fixed income.

Our clients on the whole hedge their inflation. From that point of view, not much re-allocation has been needed. Their inflation metric is normally 5% limited price indexation, so when inflation hit double digits, they were way over hedged. I don't see the attitude to inflation-hedging changing much because our clients have moved so much away from equities.

It is still, however, relevant for real assets. We are seeing some interest in long inflation-linked cashflows in infrastructure, but it is not something people try and build into their fixed income portfolios. They do it through LDI mandates if they are going to do it.

**How big a risk is inflation for investors longer term, say over three to five years?**

**Forest:** When you look at the curve positioning, three to five years are the best maturities today in terms of carry and roll-down, especially in the US.

In this new regime it makes sense to be balanced, to have more fixed income, to look at liquid investments, especially if we are expecting more volatility next year. And I agree that spreads do not price in a recession.

In emerging markets, local currency in the long-term perspective is something we like. You are talking about Brazil, but we can also mention Mexico as offering attractive medium-term opportunities for bond investors.

**Nazir:** Inflation is always a concern for most of our clients, but less profound than initially thought at the start of this inflation cycle, given it also impacts their liabilities. Five-year breakeven has come down to around 2.1% and two-year breakeven in the US is around 2.5%, which explains that while it was a concern for markets at the start of the year it is less of a concern now.

Additionally, our clients also allocate to equities as a hedge against inflation. There were significantly higher allocations to equities ahead of the rate hikes, but we have seen some de-risking since, and they are not as concerned about inflation as they were maybe 18 months ago.

Overall, from an inflation perspective, we have seen incremental additions to gilts and inflation-protected treasuries, but less so year-to-date than what we saw last year.

**Logan:** Some emerging markets are now less dependent on foreign funding. They are building out their local markets.

**Forest:** When we talk about emerging markets, we need to talk about China. We are in a situation where Chinese bonds are becoming less attractive, especially compared to US bonds. We have to be selective for emerging markets because valuations are not the same for all countries.

**Next year there will be elections here, in the US and in the EU. How could they impact the bond markets?**

**Darling:** One of the biggest reasons people are attributing the spike in real yields over the summer to is investors getting their head around how much money the US government wants to borrow.

I'm not a great believer in supply kills the bond market; when people are scared enough, they will come back to bonds. The point is, among most Western governments there is not much fiscal restraint. They will spend as much money as they are allowed to. There is no appetite for running balanced budgets, for getting their house in order.

In the US, you can't ignore the politics, but it does not matter who wins in terms of the economy. The Democrats are not a tight money party, and the Republicans are no longer a tight money party. Whoever wins, will spend what they can spend.

What is interesting about the UK is we had a horror moment last year with Truss and the credibility of the Bank of England. The weird thing now is that the UK is running quite a tight ship. That has not been appreciated. Politicians have been scared by that event. If you look at their spending plans, if you look at the tax burden in the UK, it feels like we are just grinding back towards potentially quite a slow growth disciplined ship.

We liked UK assets at the start of 2023, where you got a lot spread premium for buying the UK, because we were almost trading like a distressed emerging market.

And I wonder if as things settle down, the election is going to be between a relatively bureaucratic incumbent and a challenger who is trying to be very middle of the road. We will have a political campaign without anything too extreme on the economic side. And maybe that could be a bit of a tailwind for UK assets.

**Over the medium term, bonds look more attractive than equities.**

Umer Nazir
Portfolio manager, fixed income
London CIV

> **There are lots of ways of getting impact into your portfolio rather than using green bonds.**
>
> Kate Hollis
> Global head of credit, manager research
> Willis Towers Watson

**Forest:** European elections will be important. I see three big questions for them.

The first is debt sustainability. There is no agreement between France and Germany about the debt sustainability rules, which is a big challenge. Europe does not have the same level of budget deficit as the US, but we have higher interest rates and the question of debt sustainability will come back. So the European election will be important to define the new set of rules regarding debt sustainability.

The second point is growth. You are expecting a US recession, but we are observing that the potential growth of the United States is higher than expected, thanks to immigration. In Europe, I'm afraid growth is close to zero.

And what is the impact of the Green Deal on growth? What are the next steps regarding the measures to stimulate growth in Europe?

Last but not least, are the measures set by the von der Leyen commission for the green transition: ESG, SFDR, etc. The commission has been one of the biggest defenders of the ESG transition. We are observing a push back in ESG sentiment in Europe and the next commission should define, validate or not, the different measures for ESG. So European elections are important.

**Logan:** What you have touched on with the UK and then some countries in Europe comes back to your earlier quote about the discipline that can be enforced on countries through the bond market. Effectively, that is what we saw last year in the UK and in a lot of peripheral European countries during the euro crisis.

But we have not seen it in the US. Clearly, it has a unique advantage as the global reserve currency. That is, to come back to our earlier discussion about Covid stimulus and inflation, a mechanism in which inflation could be persistently higher in the US relative to the UK or Europe because they will be able to continue to spend. How that manifests itself and the implications for that, on the bond market and other areas, is something that we have to watch and consider.

### Is it worth paying for active management in these markets?

**Nazir:** Fixed income is hard to replicate in indices. It is a different asset class to equities in that you have maturities to deal with. So passive makes less sense.

We do not have a passive fixed income strategy. We do, however, have a buy and maintain fund, which is where we have seen a lot of demand. It is not a maturing portfolio, but one with constant duration.

In terms of fees, we don't have the beta tailwind we had over the last five or six years where with lower rates it was easy for any duration fund to deliver good returns. But going forward, where you position yourself along the curve, which credit sectors you pick will be key, so it makes sense to pay active fees in fixed income.

ESG is another added element of why you would pay an active fee. That is another place where I have seen a lot of progress. We went to the market looking for a sterling active fund, looking at what managers are capable of doing in terms of ESG. We then went to the market five months ago for another mandate, and I saw a tremendous improvement with managers doing a lot more in terms of ESG.

**Wellesley:** Putting ESG into the fixed income arena was difficult to do a year or two ago but is now a lot easier. It may not be done for all the right reasons other than winning some business, but it has become a lot more prevalent, and, therefore, on the active side it is important.

Obviously, buy and maintain active management is important. Aside from anything else, security selection is important. Then it is trying to understand what it is you are trying to achieve with fixed income. Normally, it is something that wouldn't be reliably provided by something across a board index.

I tend to be more favourable on the active side. I'm not a big fan of fees but you get your money's worth in fixed income to a large degree.

**Forest:** If we are expecting more defaults and credit spreads to widen, it will become important to be active.

If we want to avoid defaults, it is important to have a good credit analysis. We are also integrating ESG factors, which is important. If you are passive, it is not the best solution for the coming years.

**Logan:** You are expecting a buy and maintain fund of short-dated, high-quality investment-grade credit to deliver for your members at a relatively low cost.

Whereas, if you are looking at an unconstrained emerging market debt mandate where the amount of credit research and work that needs to go into that is clearly a lot greater, then you have to pay for that. And if you are not, you might be concerned that the investment work is not being done.

It is about value for money. Clearly, as an asset owner, it is on us to scrutinise the managers.

**Wellesley:** The same thing applies in high yield as emerging market debt. These days, particularly with all the comments that we made earlier about how companies are going to go under, security selection is vital. You would want a high-yield manager who knows what they were doing and understands the underlying trends that can affect issuers.

**For longer-dated bonds, the sustainability of the company is absolutely crucial.**

Callum Logan
Head of investment strategy
Coal Pension Trustees

**Kate, how is fixed income meeting the sustainability challenge?**

**Hollis:** We are working with managers to make sure they are integrating ESG into their processes. I had a slightly disastrous call not so long ago with a portfolio manager and a credit analyst where it became abundantly clear that ESG was something that was done by the ESG team who are kept in a cupboard and consulted only when necessary. It clearly wasn't anything to do with the standard credit analysis and the standard portfolio construction.

Is ESG properly integrated? Is it being properly reported on, by which I mean mandate level TCFD reporting, mandate level climate transition risk reporting and mandate level engagement reporting? And are the managers engaging with all the credits in the portfolio, not just the ones who have listed equity?

If the answer to all that is yes, and it isn't yet at many managers, but we are getting a hell of a lot better than we were, then we can move on to the next stage, which is: our clients have the information about what you are doing for them in the portfolios. Then we can start digging down into the exact details.

We don't mind if you have somebody who is a high emitter if they contribute to the solution. Electricity generation transmission companies, for example, generate heat that counts as emissions, they are always going to be high emitters, but we are never going to decarbonise unless we have a lot more electricity transmission and someone has to finance that.

Our clients are also looking at impact in private debt where you could be a lot more targeted in what you invest in. You can also build in covenants, coupon ratchets and all sorts of things to make sure that issuers do what they say on the tin.

**How are asset owners making the money they lend sustainable?**

**Nazir:** There was a perception that equity holders will have a say, as they get a seat at the table, and bondholders don't. But there are still many other things you can do as a debt holder.

One key area is the labelled bonds where we can see direct outcomes. That is a segment of the fixed income market which was in its infancy a few years ago, but now represents a sizeable opportunity. Hopefully, now there with more scrutiny, we are improving the clarity on use-of-proceeds for these bonds, which then gives you a more measurable ESG outcome.

**Hollis:** There are lots of ways of getting impact into your portfolio rather than using green bonds. We have nothing against green bonds if they are truly green and are at the right price. Five or six years ago, an awful lot of companies were issuing lots of green bonds because they thought: "There is all this money there and we can issue a bond which has a meaningless label and can save ourselves four basis points."

Everybody has tightened up on that. But there are many, many ways other than green bonds to get ESG and impact into your portfolio. If you are going to only invest in green bonds, tick the box, job done – that was a five years ago story.

**Darling:** The level of work and disclosure have improved but importantly, for the managers at a company level, you could argue that the whole focus on ESG is achieving what it is supposed to do. If you are an issuer, investors have ESG, either through explicit mandates or exclusions, and you need to come up with better answers.

In the high-yield market, for example, one of the biggest issues has been information. If you are dealing with a smaller or less sophisticated company, two or three years ago a lot of them didn't understand what the fuss was unless they were in a contentious sector. Now they realise that investors want to know what is being done to support the transition.

I agree that it is a terrible idea to have an exclusionary policy that stops you investing with companies that are trying to improve. But there is no doubt that it is being made easier for managers, because now you get more information as companies understand what they need to provide and why it is important.

That is improving the average quality of the opportunities. It is no longer ESG and not ESG – you have a market where the general level of awareness and knowledge and policies are improving.

**Hollis:** That's true even of issuers that are owned by private equity. Three years ago, I was told consistently by managers that they can't get these guys to engage; all they were interested in was the financials.

Then it dawned on the private equity managers that if they want to IPO some of their holdings, they were going to have to produce the ESG numbers. They suddenly realised that it is important for them, too.

**Wellesley:** But if I look at the private debt mandates that exist in the schemes I'm involved with, there is very little so far. I'm glad to hear that there is another motivation with the IPO market to get them moving in that direction.

But there is lip service: "Oh, yes, it is integrated into everything we do." But the evidence is not presented.

There just haven't been the drivers, it has been purely financial. I haven't seen much ESG engagement yet but I'm encouraged that I'm going to see more of that.

**Hollis:** We are pushing hard on reporting in private debt, in particular. In the public debt markets, we are engaging with managers and so will all our peers. There are some big pools of money looking at impact private debt and a lot of private debt managers are waking up and realising that this applies to them, too.

**Forest:** More than 70% of Candriam's assets are ESG related. We are following SFDR regulation and have article 9 funds for all asset classes.

We have been developing our ESG model for more than 20 years. It is not easy. It is always a question of data, of reporting and of the materiality of the ESG indicators we are using. It is a long road. But there are plenty of opportunities, especially in fixed income.

The climate is becoming a big risk for bond investors. So we have to incorporate it but it is a question of how do we incorporate that in terms of data and how we monitor and explain that to a client and in the reporting.

And today for us, the big demand from our clients, especially French and German clients, is not about climate, the big question is biodiversity.

That is another step, but that is the big question: tell me how you have an impact on biodiversity. So it is becoming more and more sophisticated.

**Nazir:** Biodiversity and natural capital are the two key issues that we are currently discussing with our clients. In the last three or four months, it seems to have shot to the top of their priorities.

Overall, I agree that the ESG credentials and data disclosure has improved immensely across the field. However, there are some asset classes which are still laggards, and faced with complexities, for instance, data coverage for securitized assets. Lastly, in terms of ESG optimisation, there are many ways that investors are currently looking at it: index customisation, positive screening, ESG integration, the best-in-class issuers that the managers will have on the ESG ratings.

**Logan:** It is also about being transparent about what you are trying to achieve. We have a fiduciary duty to our clients in terms of delivering returns. That can be complemented with impact, but you have to be clear about what impact it is you are trying to achieve.

And as we are seeing more information and more disclosure, it is all the more important for asset owners to hold managers to account on considering ESG risks within bonds. In particular, for longer-dated bonds, the sustainability of the company is absolutely crucial. Because you are not going to get your money back for a number of years, you need to consider all of those factors in that decision-making process and it is on us to hold the managers to account.

**I'm not a big fan of fees but you get your money's worth in fixed income to a large degree.**

Gerald Wellesley
Client director
Vidett

**What can we expect from fixed income markets going forward?**

**Wellesley:** The average age of an American is 33, so they will not have experienced anything but rock bottom interest rates during their adult life. The effect of the new interest rate environment is an eye opener, in lots of ways.

There is quite a lot of adjustment to thinking about bonds in a different way. To secure a yield of 5%, 6% or 7% requires a lot of rethinking. It is going to be quite an interesting year or two for bonds from that perspective.

**As an active manager, you should welcome volatility and complacency.**

Adam Darling
Investment manager, fixed income
Jupiter Asset Management

**Nazir:** Over the medium term, bonds look more attractive than equities. The yield on US corporates is 5.4%, global aggregate is 5.6%, so over the medium-term fixed income seems like a better proposition.

**Forest:** The cost of debt has become higher for sovereigns and corporates, so the question of debt sustainability will come back in 2024. We are talking about deficits and higher interest rates, so how can we add a sustainable debt dynamic? That will become an issue and is something that we need to monitor.

**Nazir:** It is good to see someone concerned with the debt issuance in high yield because whenever I speak to managers, there are two reasons that are always highlighted and perceived to negate those concerns. The first is that the quality of high yield as a universe is much better now. The other is the maturity extension argument, i.e., corporates are not hitting the debt maturity wall yet, so it was good to hear a contradictory view.

**Darling:** Forecasting the future is difficult and if you work in markets that is inherently what you are trying to do. The good thing about working in fixed income at the moment is, for the first time in probably a decade, your yield is high, giving you more scope to make mistakes.

It also gives you as an underlying investor more comfort that if you are buying today, you can look forward to six months of volatility, 12 months of volatility or 18 months of volatility. If you take a two, three or four year time horizon with starting yields where they are, you have a much higher prospect of making positive returns.

**Hollis:** Part of the reason why the quality is higher is because so much got downgraded. There were so many fallen angels in 2020, which haven't been upgraded. There are a lot of rising stars which have been updated by one agency but not the other two.

You have to be careful because indices are funny things. The next issue you could have if all the recent fallen angels are upgraded is that the quality of the high-yield index has gone down.

**Darling:** A lot of the analysis that goes into a credit rating is backward looking. When we talk about the credit quality of the market, it does not tell us what the market will look like in 12 months' time, if we are in recession, in inflation or deflation.

As an active manager, you should welcome volatility and complacency. That is the best environment where you have scope to do things differently and maybe find some alpha.

**Logan:** The forward looking aspect is the real challenge we are all faced with, whatever side you are coming at it from. The central banks have abjectly failed in terms of inflation. You can blame the Covid stimulus, but ultimately the central banks have been given a mandate, and inflation continually overshot and they were far behind the curve. People are looking at: will the Fed hike? Will the Bank of England hike? But they have reached a point where a lot of their models are broken, they have even said it. Increasingly they are data dependent. Don't look at what the Fed is doing, look at what the data is telling you. Because from here, there is a lot of uncertainty about those long and variable lags in monetary policy, where inflation goes from here has such a huge impact in terms of that decision-making process and how that influences fixed income.

Look at the hard data and the numbers that are coming through, because that is what the central banks will be looking at.

# THE FINAL COUNTDOWN

## $1997.60

The price of gold hit a three-month high during November due to global events, rising oil prices and inflation.

Source: The Royal Mint

## 92%

...of life insurers in Europe intend to make investments that have a potential environmental or social impact.

Source: Alpha Real

## 24%

Around a quarter of institutional investors intend to dramatically increase their allocation to private debt in the coming year.

Source: Aeon Investments

## 64%

The majority of UK institutional investors are considering moving their real estate investments abroad. Inflation, working from home and high interest rates were cited as reasons.

Source: Gallagher

## 55%

...of defined benefit schemes are targeting buyout.

Source: Aon

## 15%

The level of listed real estate companies which have set net-zero targets on all three scopes by 2050, up from 10% a year ago.

Source: Van Lanschot Kempen

## 94%

The level of investors who believe corporate reporting on sustainability performance contains unsupported claims.

Source: PwC

## 65%

The defined contribution schemes that say inflation has made them think harder about investing in renewable energy and sustainable food production to boost the UK's economic resilience.

Source: Legal & General Investment Management

## €15.2bn

The inflows to Europe's ETFs during October, while €19bn left mutual funds.

Source: LSEG Lipper

*Quote of the Month*

**"At the end of the day, change is not going to happen on the basis of nice disclosures. It is going to happen if people start behaving and investing differently."**

Tim Manuel, Aon

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