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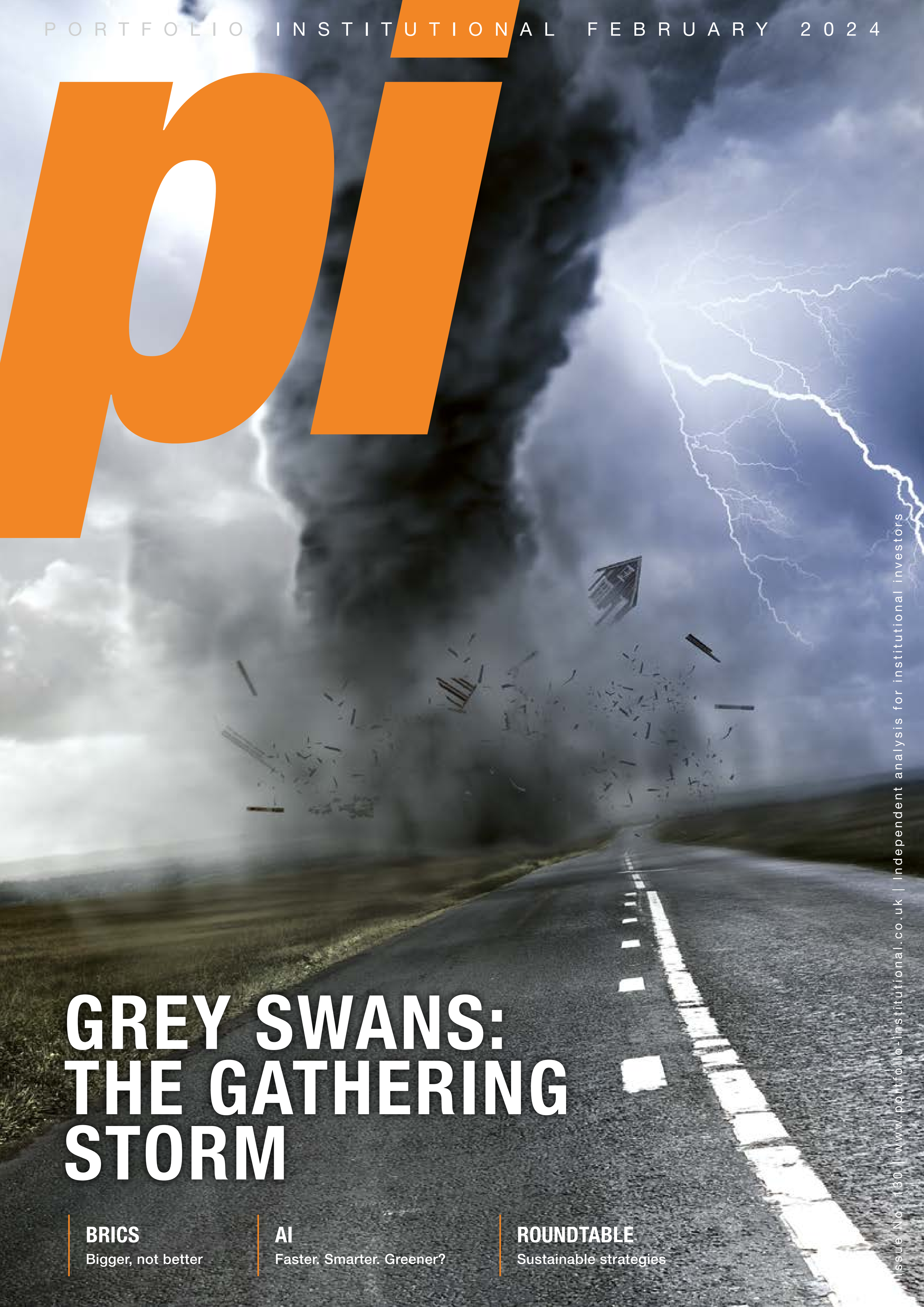

GREY SWANS: THE GATHERING STORM

BRICS
Bigger, not better

AI
Faster. Smarter. Greener?

ROUNDTABLE
Sustainable strategies

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GREY SWANS: THE GATHERING STORM

For investors, danger comes in many shades.

There are red flags, which are obvious threats. Then there are black swans, which are not so easy to spot. Well, now investors have to watch out for grey swans, which are rare, but high impact, events.

This is going to be a year of high geopolitical risk, not just with the threat of other groups being pulled into the Hamas-Israel war, but people in more than 50 countries will vote in national elections. So expect the unexpected in 2024. Expect a grey swan or two to fly past your portfolio. Our coverage starts on page 16.

Another threat comes from artificial intelligence. It is gaining more influence over our lives and is touching many, if not all, sectors. We look at how it will impact the ambitions of pension schemes to decarbonise the global economy, protect the natural world and close the inequality gap. Read our take on the issue from page 28.

Meanwhile, the Brics group of emerging nations has welcomed six new members with the aim of taking on the G7. It doesn't look good, especially with Argentina leaving before fully joining. We look at why bigger is not proving to be better in the case of the Brics from page 34.

High inflation has contributed to bonds becoming competitive with other assets once again, but what impact would a fall in the price of goods and services have on the asset class and how effectively are we measuring it? Read all from page 46.

Our roundtable discussion this month looks at sustainable strategies. There are many ways to build a sustainable portfolio with cutting carbon emissions, conserving freshwater, producing food without damaging the ecosystem and promoting high standards of human rights just some of the options available for those wanting to build a greener and more equal world.

We invited a group of asset owners along with their managers and those advising them to discuss what they want from sustainability and where it can be found. (Page 38).

We also sit down with Dan Mikulskis, who from page 12 discusses his new role as chief investment officer of The People's Partnership and explains what it is like switching from being an adviser to a hands-on investment role.

Finally, the head of sustainable investment at the Cambridge University Endowment Fund explains how she is positioning the portfolio for a net-zero world and why she doesn't care much for labels (Page 24).

Mark Dunne

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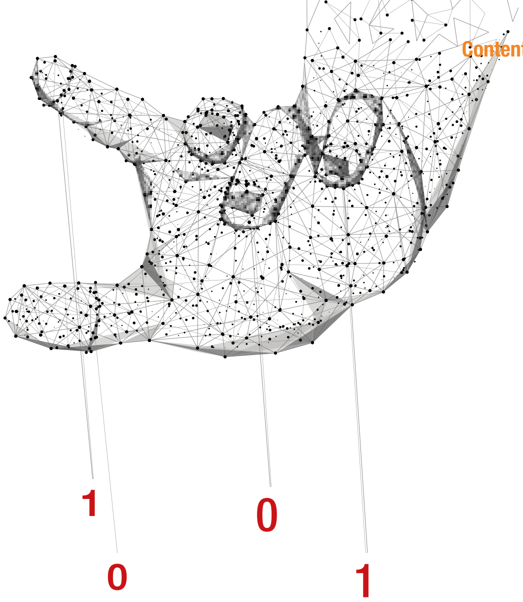

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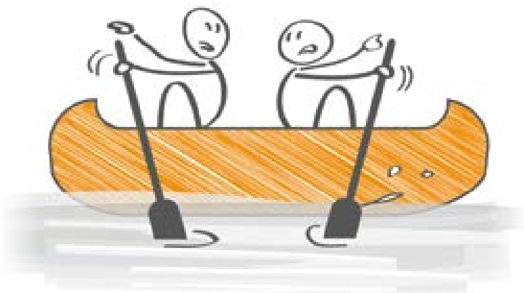
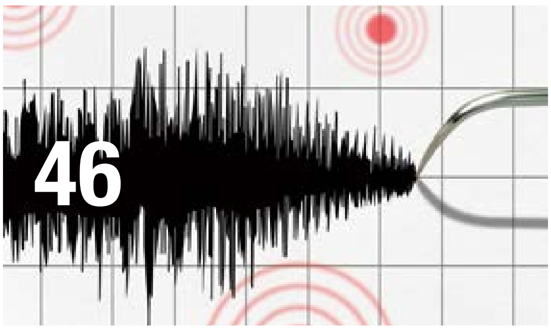




INVESTOR OUTLOOK: ALL CHANGE?

Could an uncertain start to the year force investors to re-think their expectations? *Andrew Holt* reports.

Stocks and bonds faced some upheaval in early January as markets pulled back on long-held expectations of interest rate cuts while inflation saw an unwelcome return. The FTSE100 saw its deepest dip since August. But the fall went across the Atlantic – always a bad sign – hitting the S&P500 and the Nasdaq.

The sell-off followed suggestions from European Central Bank president Christine Lagarde that market expectations of a rate cut were "not helping" but offered some light by saying a cut may come by the summer. Talk about mixed messages.

Inflation also jumped to 4% in the UK during December. Hardly part of Rishi Sunak's plan for an election year. Investors are pulling back on an expected Bank of England rate cut. But where does this unexpected turn leave investors?

Julian Howard, lead investment director of multi asset at GAM Investments, notes how the start to the year for stocks and bonds has not been a clear continuation of where we left off at the end of 2023.

"The Fed declared in December that the rate cycle was done and the not unreasonable assumption was that stocks would keep rallying and bond yields sink as growth and inflation expectations were tempered," he said.

Two factors have contributed to this trend, Howard said.

"Firstly, stocks were already expensive and priced fairly close to perfection. The equity risk premium on the S&P500 is still marginal. The forward earnings yield on that index is 4.5% but the 10-year US treasury yield is 4.2%," he added.

Investors are, therefore, Howard said, only getting 0.3% more than the risk-free rate, naturally tempering the prospects of a runaway rally. "For more progress to be made from here, the fourth quarter earnings season would have to be spectacular, or bond yields would have to sink," he said.

This brings us to the second factor. "Bond yields are not falling, because inflation and growth expectations have not been significantly revised down. The final mile of the current inflation fight could be somewhat prolonged," Howard added.

Inflation spectre

It is a point shared by Simon Nichols, multi-asset manager at Newton Investment Management. He said that monetary policy continues to be a key driver of returns in bonds and equities, but the spectre of inflation also haunts the outlook.

"The future path of inflation will be key in determining the extent and timing of any relaxation in policy and markets have moved aggressively to anticipate a looser policy environment over the coming year," he said.

Uncertainty remains around whether inflation "can be reduced from a normalisation of supply conditions" or if a "cooling in demand must also play its part", Nichols added.

For now, investors are content that a 'soft landing' is in prospect, Nichols said. "Geopolitical issues continue to have the potential to disrupt this pathway via commodity-price volatility, supply-chain logistics disruption and trade sanctions, among other factors," he added.

There is an additional issue wrapped up in this. "While lower interest rates and bond yields ameliorate a key pressure on consumer and corporate spending power and support asset valuations, volatility in key financial metrics is unhelpful for certainty and long-term decision making," Nichols said.

Political problems

Furthermore, as we note on page 16, politics is likely to rise up the agenda for investors as the year progresses, with elections taking place in many regions, not least in the US.

"Policy emphasis is likely to affect the outlook for several sectors exposed to partisan spending outlooks," Nichols said. "We remain focused on those companies which we believe have more resilient long-term earnings profiles and attractive end-market outlooks."

But there continues to be debate surrounding the soft landing scenario, which adjusts the outlook somewhat. Anthi Tsouvali, multi-asset strategist at State Street, said: "We find the chances of achieving soft-landing slim. Higher interest rates mean it is much harder and more expensive to get access to financing."

Therefore, Tsouvali added: "Higher for longer will likely progress in a way that poses additional threat to corporate margins, followed by a more serious rationalisation to employment."

Such a scenario, says Tsouvali's colleague Marija Veitmane, head of market research at State Street Global Markets, "means that equity multiples and earnings growth expectations are too high warranting more cautious equity allocation.

"Analysts' expectations that we've seen reveal a trough in earnings and are forecasting a strong reacceleration, not just in the US, but in ex-US markets as well seems overly optimistic and will have to re-adjust lower," Veitmane said.

Mike Coop, chief investment officer of Morningstar Investment Management Europe, sums up the situation: "Over the past year markets have swung from gloom to boom as growth and inflation turned out better than expected, after the biggest rise in rates for decades."

Coop added that there are scenarios that could lead to "inflation surprises and so investors should be prepared for a range of outcomes". "Investors are best served by staying focused on longer-term investment strategies designed to meet their goals and filter out short-term swings in market prices and investor sentiment," Coop said.

IS CHINA IN CRISIS?

The world's second largest economy faces big challenges, but there are also opportunities. *Andrew Holt* reports.

January saw markets in China go into meltdown as confidence in the economy, like magic, suddenly vanished.

The CSI 300 index, which replicates the top 300 stocks on the Shanghai and the Shenzhen exchanges, dramatically fell to a five-year low, while the Hang Seng China Enterprises Index, which tracks Chinese stocks traded in Hong Kong, plummeted to its lowest level in just short of two decades. But what is behind this and how should institutional investors react?

Economist Mohamed EL-Erian said China faces the risk of two major economic and financial problems. The first is insufficient domestic growth drivers in the face of external headwinds. The second is long-standing pockets of excessive debt and leverage turning into system-wide detractors of growth, confidence and capital availability.

Opportunity knocks

But with every crisis comes an opportunity. This is the position of Andrew Lapping, chief investment officer at Ranmore Fund Management, who sees the situation as a positive.

"We see the sharp decline in the Chinese market as an opportunity," he said. "As an investor it is important to take advantage of opportunities when they arise, this is often difficult as the crowd is usually moving in the opposite direction."

Lapping admitted there are risks in China but, "there are risks everywhere, and it depends on what is in the price". Putting the situation into some context, Lapping noted that during the past year the S&P500 is up by more than 20% while the Hand Seng has dropped 30%. "There is no way underlying business values have diverged to this degree," he said. "This underperformance, particularly over the past month, has given us the opportunity to buy high quality, well capitalised businesses at very low prices – an exciting opportunity."

Norman Villamin, group strategist at wealth manager Union Bancaire Privée, has taken a different view: exiting China. He noted that investors should be selective when approaching the country, as it is no longer the case of getting into China based on its dramatic growth narrative. Today, he said, the story of China is more complex as there "are some sectors that are going to have a very hard time". So investors need "to be more selective in terms of the companies that you buy".

Jian Shi Cortesi, investment director and fund manager of Asian and Chinese equities at GAM Investments, sees three outcomes to the current situation. First, investors are pessimistic. Second, pessimism leads to depressed valuations. Third, depressed valuations create opportunities to buy good companies at cheap prices. "If you were a Warren Buffett-type of investor, the current Chinese stock market would make you very excited," Shi Cortesi said.

Josh Snyder, global investment strategist at GQG Partners, warned that "policy whiplash" initiatives have also stifled investor interest. This, he said: "Is one of the primary drivers of our relatively persistent underweight to China since mid-to-late 2021, where the regulatory whiplash, has tended to have the greatest impact on new economy names thus driving us into more old economy names for what little exposure we maintain."

Shi Cortesi said that many institutional investors have significantly reduced their weighting to China or now have no exposure to Chinese equities. This, though, could be a flawed approach, she said. "As Chinese stocks have become cheap and the government has become more and more determined to lift the stock market, underweight positions in Chinese equities could lead to underperformance should China's stock market start to rally. This is a risk for institutional investors to look out for," she said.

Given the severity of the events, the government has been forced to act. Bloomberg reported that the Chinese government is considering organising around ¥2trn (£222bn) from the offshore accounts of state firms to buy shares onshore.

Commenting on this, Shi Cortesi said: "The latest indication shows that the government certainly wants the capital market to perform better. We expect to see more national team buying, which historically tended to be around market bottom levels. Companies themselves are also speeding up share buybacks."

Capital shift

Inevitably, there is something bigger being played out within the China crisis. "Investors have recently witnessed Western capital gradually, but steadily, shift away from China as companies have diversified supply chains and struggled to navigate rising tensions between the world's two biggest economies," said Meghan Bruni, investment strategist at Newton Investment Management. "We believe that studying private-markets data and cross-border capital flows, as well as qualitative evidence, can enhance our understanding of the implications of recent trends," Bruni added.

But some data can murky the picture. According to official statistics, China's economy grew by 5.2% in 2023. Yet analysis from data company Rhodium said that with problems in its property sector and high levels of local government debt, actual growth in China during 2023 was closer to 1.5%.

Nevertheless, a mass China investor exodus is unlikely. "We do not believe that companies and investors will completely walk away from China, but a cautious and nuanced approach is warranted, with an eye toward diversifying risks," Bruni said.

PEOPLE MOVES

Tom Joy is to leave the **Church Commissioners for England** in April after 14 years as its chief investment officer to join an un-named organisation overseas.

Since he took up the role, the endowment has grown to £10bn from £4bn and distributed £3.5bn of investment returns to the Church.

Railpen, the fiduciary and investment manager of the £34bn railway pension schemes, has named **Maura Sullivan** as its next chief investment officer. She replaces Stu Blackett in April when he retires.

Sullivan has been a non-executive director since 2022 and has served as deputy group financial officer at wealth manager Quilter. She also has roles at Credit Suisse, Morgan Stanley and JP Morgan Chase on her CV.

Pension pool **London CIV** has appointed **Aoifinn Devitt** as its chief investment officer (CIO). She knows local government pension schemes well having advised them on asset allocation, the pooling process and responsible investing for almost 20 years.

Devitt will leave US-based wealth manager Moneta, where she is CIO, for the role. She has held several senior roles including head of investment for Hermes Fund Managers in Ireland and for the Policemen's Annuity and Benefit Fund of Chicago.

She has also been an independent adviser to four local authority pension funds in the UK and held various investment committee positions. Devitt founded Clontarf Capital, a pan-alternatives research and consulting firm, and has worked for Goldman Sachs and Cambridge Associates.

Now Pensions has welcomed **Keith Guthrie** as head of sustainability. He will also hold the same role at investment manager Cardano, where he was previously deputy chief investment officer of Cardano Investment.

The Pensions & Lifetime Savings Association (PLSA) has promoted **Joanne Fairbairn** to chair its defined contribution committee. The client director of Zedra, who has been a committee member since 2018, has also joined the PLSA's policy board.

Fairbairn joined Zedra in 2021 after holding pensions roles at Marks & Spencer and Tesco.

Finally, professional trustee provider **Independent Governance Group** has opened an office in Manchester.

Trustee directors Graham Bryant, Catherine Edmondson, Nicole Mullock and Janine Wood will be based in the office.

CALENDAR

Topics for upcoming *portfolio institutional* events:

February
– Multi-manager portfolios roundtable

February
– Fixed income roundtable

25 April
– Private markets conference

May
– Defined contribution roundtable

June
– Emerging markets roundtable

03 July
– ESG Club Conference

September
– AI roundtable

24 October
– *portfolio institutional* Awards

November
– Natural capital roundtable

NOTICEBOARD

The Scottish Borders Council's £900m pension fund has made its first allocation to natural capital assets. The scheme has invested an undisclosed sum in Nuveen's Global Timberland strategy.

Aviva, through its asset manager Aviva Investors, has invested £50m in the **Hightown Housing Association**, which owns more than 8,700 homes, care homes and supported housing projects across Hertfordshire, Buckinghamshire and Berkshire.

The funds will be used to build energy-efficient affordable housing as part of its plan to bring more than 1,000 homes to the market in the next two years.

Pensions Insurance Corporation (PIC) has lent £30m of secured debt to the **Heart of Medway Housing Association**.

The 20-year debt, £10m of which has been deferred for two years, means the insurer has invested £160m in the affordable and shared ownership housing specialist.

The pension scheme for the UK workers of engineering company **KBR** has appointed **Legal & General Investment Management** (LGIM) to help prepare it for buy-out.

The fiduciary management mandate covers more than £1bn worth of assets and LGIM will help the scheme, which has more than 9,000 members, meet its Solvency requirements and restructure its private markets portfolio to improve liquidity.

The pension scheme for The Electrical Safety Council, **NICEIC**, has completed a £66m full buy-in with **Just**, securing the benefits of almost 400 members.

Just has also completed a £60m full buy-in of the remaining uninsured liabilities of the **Hyde Housing Association Limited Pension and Assurance Scheme**.

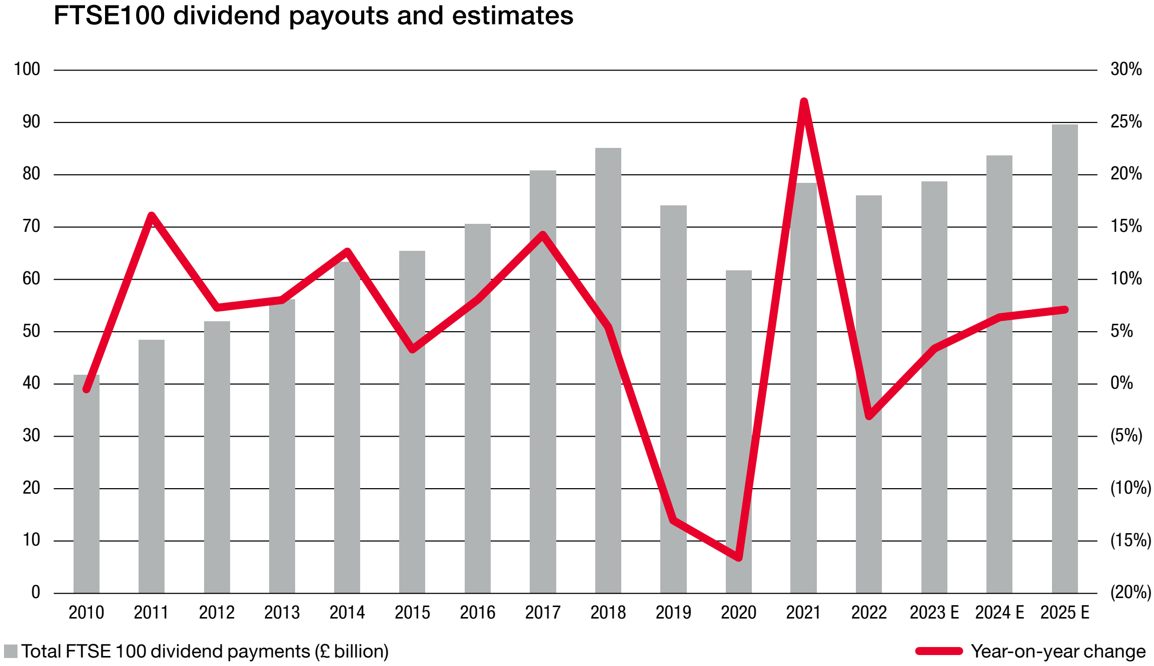
Then there was **Just's** £28m buy-in of the pension scheme sponsored by **CP Pharmaceutical**, which will now proceed to buyout and ultimately be wound up. The deal insured the benefits of 46 pensioners and 271 deferred members.

Also announced in January was Just insuring the benefits of the **Intersil Limited Superannuation Fund**. The £1.5m full scheme buy-in of the scheme serving employees of semi-conductor maker Intersil was completed in August but was not announced until this year.

PIC has concluded a £65m full buy-in of the retirement scheme sponsored by **Chemring**, which provides technologies to the aerospace, defence and security markets.

Finally, the insurer has also covered the pension liabilities for 125 pensioners and 107 deferred members who were employees of **Westminster Abbey** in a £25m deal.

THE BIG PICTURE: BLUE CHIP DIVIDEND ESTIMATES CUT



Source: Company accounts, Marketscreener, analysts' consensus dividend forecasts

Analysts have reduced their dividend forecasts for 2023 and 2024, but still expect the FTSE100 to have broken pre-tax profit records last year, finds *Andrew Holt*.

The FTSE100 seems to be going nowhere. The UK index of blue-chip companies is no higher than it was 12 months ago, or, it should be noted, where it was six years ago.

Yet the index could still appeal to patient income investors, given a forecast dividend yield of 3.9% for 2023 and 4.2% for this year, according to stockbroker AJ Bell.

Although an inflation rate of 4.6% and a 10-year gilt paying 4% means those numbers do suffer a dint.

The dividend forecast for last year is based upon estimates for a 3.8% increase in total dividend payments to £77.8bn.

An anticipated 9.5% increase in pre-tax income to a record £250.7bn offers support to those assumptions. But the underlying net profit is expected to drop across the FTSE100 by 13.5% to £168bn, thanks in part to higher taxes.

That will not help dividend growth, and although analysts are looking for an 8.6% rebound in adjusted net profit this year that would still leave earnings below 2022's peak.

This is understandably influencing boardrooms when they ponder what is the correct amount of cash to return to shareholders.

The forecast of £77.8bn in ordinary dividends is 9% below 2018's record £85.2bn pay out, to reflect a combination of factors: the aftermath of Brexit, Covid, the return of inflation, higher taxes, increased wages and a surge in interest rates.

Interestingly, analysts have even shaved £900m off their aggregate dividend payment forecast for 2023, and sliced £1bn off 2024's projections, in the past three months alone.

Nevertheless, analysts are still expecting an all-time high for aggregate FTSE100 pre-tax profits in 2023, at £250.7bn, which represents a 9.5% increase on 2022's outcome and a huge improvement on the previous peak of £195bn in 2018.

However, that forecast has slipped by nearly 10% from £275.5bn during the past 12 months, as estimates for the banks, miners and oils have been trimmed back to varying degrees.

Estimates for 2024 continue to drop as well, although consensus forecasts now expect the FTSE100 to eke out a 3% improvement in pre-tax income next year to what would be a new record of £258bn.

George Dollner is policy lead at the Pensions & Lifetime Savings Association.

HOW SOCIAL FACTORS SIT IN THE PLSA'S WIDER RI WORK

As we settle into 2024, responsible investment remains at the forefront of our plans. We are seeking to ensure that the UK regulatory framework for investments facilitates pension funds in achieving their investment objectives, including where it pertains to ESG investing or stewardship. Work is already well underway, including for our annual *Stewardship and Voting Guidelines*, which provide our members with a benchmark for their corporate reporting and investor relations. The guidelines share practical guidance as well as highlighting policy issues to consider when reviewing corporate governance and voting policies.

Throughout the year we will be engaging with a wide range of issues, including the Financial Conduct Authority's rules on sustainability disclosure requirements, its proposals on UK-listing reforms and anti-greenwashing. We will be monitoring further changes to the landscape closely as work is brought forward on the green taxonomy, transition plans and as we build our understanding of the recommendations put forward by the Taskforce for Nature-related Financial Disclosures (TNFD). These issues all have the potential to dramatically impact responsible investment and stewardship practices.

It's vital for our members that we emphasise ESG. One way is by supporting our members to better understand the 'S'. Environmental factors have dominated the ESG agenda due to it being a high government priority, rigorous reporting requirements and perceived simplicity in comprehension and action. Our surveys reveal that, although social factors are gaining attraction, understanding can be limited and navigating social issues can be confusing. The 'E', 'S' and 'G' are often considered in isolation, and they need not be. Many want help in considering complex measurement metrics to identify and monitor companies' social performance.

Members face growing scrutiny over their social policies and investment approaches as public awareness of social issues rises. Key issues such as diversity and inclusion, modern slavery and human rights are prompting scheme members to ask about efforts to tackle these challenges. As a result, trustees are taking a more active role in balancing responsible investment and their fiduciary duty. Of course, ESG can provide strong returns, but they may rely on a longer time horizon, and social-factor investment in particular requires extra effort and attention.

We have, until recently, had plenty to be encouraged by. The government's 2022 response to their consultation on the *Consideration of social risks and opportunities by occupational pension schemes*, outlined that trustees who fail to factor in financially material social factors would be deemed to not be fulfilling their fiduciary duty. Additionally, we were pleased to see the establishment of the taskforce on social factors, of which we have been a member, and have supported through the development of a guide on *Considering social factors in pension scheme investments*.

However, we face the challenge of ESG considerations being deprioritised from the UK government's current political agenda. Global economies prioritise investment return and growth objectives and investors have expressed concern that the mixed signals from government risks undermining vital ESG policies. To combat this and help bring ESG back to the foreground, we collaborated with members to develop a set of social factor case studies highlighting best practice. Many of our members are doing excellent work in impactful investing while maximising member returns. These case studies provide tangible examples from across the investment cycle to support members in navigating challenges posed by social issues. From helping to highlight how to approach investing with impact, through to specific examples that demonstrate what opportunities are available, ensuring social issues remain a focal point in pension scheme thinking.

The PLSA has consistently advocated for socially responsible investing, and we want to further support industry initiatives in altering investment and stewardship strategies to help pension schemes play a leading role in investing with impact. Look out for our upcoming social factors best practice publication in late February 2024, highlighting innovative work by our members in this area.

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THE PRICE OF RISK AVERSION FOR DB PENSION SCHEMES

There has been a lot of talk recently about whether UK defined benefit (DB) pension schemes are too risk averse. Whilst deliberate de-risking of investment portfolios for closed DB schemes is arguably a logical approach, is risk aversion hard-wired into the sector and is this a problem?

Economist Paul Collier and Tan Suee Chieh, a former president of the Institute and Faculty of Actuaries, have explored this concept of 'safetyism' (defined as the displacement of judgement by procedure). Its pitfalls are particularly salient in highly regulated and risk-averse environments such as DB scheme management – where decision making is often slow to evolve, quantitatively based and procedural. These conditions are too lenient on the status quo and hinder the application of judgement. Risks are often shifted elsewhere in the system from somewhere they're known, to somewhere they're unknown.

Safetyism has been a key driver for the move towards more affordable defined contribution (DC) alternatives, resulting in the transition of risk from sponsors 'known' to individuals 'unknown'. Whilst other countries have introduced collective defined contribution (CDC) schemes and other risk sharing arrangements as 'workarounds' for the provision of more stable benefits for individuals, the UK industry's inability to reach an appropriate middle ground for now has left employees harbouring certain 'risks' that safetyism has made too onerous for companies to accept.

For DB and DC, perhaps due to the long-term nature of the industry, maintaining the status quo has become embedded. Advisers are re-appointed, administrators renewed and objectives re-worded due to a defensive mindset and a lack of appreciation that not making decisions and just following process is also a decision.

Looking at the DB market, the prevailing notion is that the optimal endgame is buy-out – reinforced by a lack of established alternatives. The notion in its extreme is that it should be safer to buy-out £1.5trn of DB liabilities and concentrate this risk with a handful of insurers rather than be supported by 5,000 employers is, at a societal level, hardly convincing.

While buy-out may be a suitable choice for some schemes looking to remove funding or covenant risks, this often comes at a cost of the high premiums and the 'opportunity cost' associated with forfeiting future asset returns.

Schemes with adequate access to resources and scale to manage uncertainty may question the value of such buy-outs, considering the regulatory limitations insurers face in investing across broad asset classes such as private equity, private credit and infrastructure.

Considering all this, it is easy to appreciate where 'value leakage' and conflicts of interest may creep in at various stages of an insurance buy-out.

It is worth remembering that trustees are not only responsible for securing member benefits, but acting in members' interests. Relinquishing discretion of trustees and a surplus to insurers may be questioned – especially if the sponsor has pension risk capacity and schemes have access to the expertise to manage risks and potentially distribute benefits or surplus to members and sponsors through alternative endgame solutions.

Transitioning to cashflow-aware assets as schemes mature and using LDI or longevity swaps, may allow schemes to limit exposure to key risks and release surplus value as a scheme runs off. This is fundamentally the same approach that insurers take but with a less constrained investment universe, leaving any surplus with the scheme and sponsor.

More broadly, as an industry we need to come up with solutions for the DB to DC transition and a nuanced approach is required. Balancing certainty of benefits with minimising value leakage and retaining some risk could be a more rounded and open-minded strategy. We also need to see closed DB schemes make the right decisions for their journey plans and endgame. Procedural thinking and quantitative analysis, while essential, is not enough for decision-makers to navigate the complexities of optimal choices in pension scheme management. There is need for a willingness to think unconventionally, acknowledging that accepting the status quo is an impactful decision in its own right.

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INTERVIEW – DAN MIKULSKIS

"I am a big believer in owning your conviction as an asset owner."

The chief investment officer of People's Partnership, the provider of The People's Pension, talks to *Andrew Holt* about working in the fast lane, still being in the honeymoon phase, becoming a £50bn asset owner and the key to thinking clearly.

How would you describe your first five months as CIO of People's Partnership?

If I had to pick one word: fast. It has been a pretty fast start. I have had the opportunity to get straight into some big projects, which has given me the chance to get to grips with things pretty fast.

I love being challenged, and coming in and doing things straight away has been great for me.

Have any particular challenges stood out?

The role in respect to what I have done before is quite interesting, because half of it is familiar. Working with trustees on investment strategy and discussing asset classes and allocation is something I have done before.

But there are some different aspects. I have never been part of an organisation that has a mass customer service operation. Getting to grips with what that means for the organisation, and my role, has been an interesting new area for me.

Why move from being a consultant to a hands on investment role?

Asset owners are special. They have this independent position within an influential industry. This gives asset owners a platform to challenge the industry and shape things. I have been fortunate to work with a great number of asset owners throughout my career as an adviser.

The role was just a huge opportunity. To not only be part of an asset owner, but also get the opportunity to build one out over a period of time and exercise those judgements on investment myself.

Has it been everything you expected it to be?

It has, but it is early days. I'm still in the honeymoon phase. There is a huge cultural focus at People's Partnership around putting members first and delivering outcomes for them. And being on the investment side of things, I'm at the business end of delivering that.

What are your priorities?

I am a big fan of focus. If you are going to achieve things you need to focus on a small number of things that have the biggest impact on member outcomes.

It may seem obvious, but if you, for example, think through asset allocation from the point of view of member outcomes you may come to a different position than if you think about what is topical. So concentrating on the impact of outcomes is what I'm determined to stay focused on.

I'm a big fan of simplicity. So keeping our investment solutions as simple as we can is also a big priority. I like small teams operating with conviction. These are the things that have been at the forefront of my mind.

Looking to the future, People's Partnership is expected to become one of the UK's largest defined contribution asset owners: how does that shape your role?

It shapes it a lot. I see my role as laying the foundation to become a £50bn-plus UK asset owner, which is where we will be in four or five years' time.

I view us as an asset owner who happens to be a DC fund. I don't see us as being defined by the fact that we are a DC fund. We are an asset owner first and a DC fund second.

In how that shapes my role, it puts everything on the table – it requires me to have a deep think about our objectives: what do we want to achieve? What are our investment beliefs? What teams and systems do we need to deliver those? And the partnerships that we need, all the way through to the asset classes and the strategies and the way we want to manage those assets.

Having that £50bn-plus UK asset owner in mind is a good perspective for me when trying to build something that will endure over that period of time and be built to last.

Was that a big appeal of the role?

Absolutely. It is a huge appeal. It isn't something that you get many chances to do through your career. So that journey is fundamental. There are not many examples of pension funds that have been on that journey.

> **I like small teams operating with conviction.**

How do you see the DC market developing in the next decade?

I, and People's Partnership, look to the Australian market on how the DC market has evolved. One important issue in Australia is the concept of scale. Having more scaled up asset owners is important. A feature of the UK pensions landscape is that it has been fragmented.

I have been involved with pensions for 20 years and that fragmentation has always existed. And it is accepted as a feature. The UK industry looks at a £20bn scheme and thinks: "You are huge," whereas that is not the case when you look at global scale asset owners. It is a level bigger than that for true scale. And it is that level that the Aussie superfunds are at.

So getting to a place where there are a small number of scaled up asset owners who have the flexibility to do a lot of things well is an under-estimated aspect. But dealing in the fragmented system we have makes it difficult to envisage something else.

The other exciting thing is what we call in the profession the 'at retirement proposition' or what regular folk call 'taking out a pension'. This is going to be big over the next decade. It is why pension funds are here: to help people draw income in their retirement. But because of the maturing DC marketplace, this is going to be a big focus of what we are doing as an organisation.

On the investment front, how we invest for all of that is going to be an interesting challenge. Especially addressing those in the growth part of their investment life.

What is in your investment portfolio?

It is pretty straightforward. Our default growth fund, which is where most assets are invested, breaks down as 80% in growth and 20% in fixed income. So that 80:20 split is where we have landed. It also has an inflation-plus target.

It is implemented via index-tracking portfolios across liquid markets all around the world. We end up investing in about 8,000 companies from the US, Europe, Japan and emerging markets, with investments in government bonds and high-grade corporate debt as well.

It is a diversified mandate. But generally it is based around index tracking, which is an efficient way of delivering investment returns.

Are you planning to make any adjustments to the portfolio?

Yes. There is more on that, but I cannot comment any further at the moment, so stay tuned.

What is your investment philosophy?

I am a big believer in owning your conviction as an asset owner. You cannot outsource your core conviction. You need to own your ideas. Some of the behavioural aspects of investing are also under appreciated. The environment you surround yourself with is surprisingly important. And I believe in deep partnerships.

What do you make of the government's efforts to nudge DC investors into illiquid assets?

I get what they are trying to do. As a general observation, if you look at the Australian market, the small number of scaled up asset owners operating at a true scale means [illiquid investment] probably happens anyway. So there is no need to nudge. And more things need to be in place for it to work. I worry that there is a short cut to maturity – there needs to be more scale in

DC. An industry fund management model is an important step to consider.

Also, illiquid assets can be good investments, but agency issues are real and can cost all the extra returns investors may enjoy from those assets through paying fund managers, for example. You need proper structures in place to ensure this does not happen.

I also reject the framing of illiquids as if they are a coherent asset class. The argument that they are good investments because they are illiquid, is a bit back to front.

How important is ESG to The People's Pension?

It is important. We are a broadly diversified asset owner, or a universal owner, on behalf of our members. What that means is where you have externalities created in one company they will get internalised costs elsewhere. So we need to focus on externalities, things like pollution, carbon emissions and environmental degradation. Some companies ignore these but we do not because they have an implication elsewhere. We also have a responsibility, as asset owners, to act as responsible stewards in the businesses we invest in.

Do you bring a different perspective to the role due to your consultancy background?

One of the benefits of a consultancy background is you get to see different approaches. You get a feel of which work well and which do not. You get to see across the whole industry. We need to select the approach that works for us.

We are an asset owner first and a DC fund second.

There has been a mismatch cited in how asset owners and asset managers approach ESG. Is this something you want to prioritise?

I recognise that issue and recognise some work published on it. What the results of that research showed, which tallies with my experience, is not that there is just a mismatch between asset owners and asset managers, but there is real nuance in what asset managers are doing.

I have always felt there is a small minority of asset managers who think like asset owners. Then there is a large spectrum of the rest, all the way from thinking like asset owners to thinking the opposite way. So there are not simply two camps. And it is not just a case of trying to close the gap.

What are the big economic and geopolitical challenges going forward? And how will they impact your investment approach?

For me, the issue is trying to move away from the short-term headline stuff and draw out longer-term timeframes. I love commenting on geopolitical events, but if we stretch the timescale on what will impact on our members we have to go out at least a decade. Then, it changes what you focus on.

Of course, we don't want to just wave our hands and say, "it is all long term". That is not true either.

But on the economic front things that matter for asset allocators include: what is the stable long run rate of inflation and interest rates in the developed world? Those matter for long-term capital allocation. And then question: are we in a new environment or not? And getting a sense of what are the stable features we can depend on? These are tough questions.

You cannot start from scratch every year. Although, that said, we are in a different world today than three or four years ago, which has implications for asset allocation. But what is important is focusing on the right questions. You can navigate geopolitical events pretty well if you are diversified globally in your portfolio.

DAN MIKULSKIS' CV

September 2023 – present
Chief investment officer
People's Partnership,
provider of The People's Pension

February 2019 – July 2023
Partner
Lane Clark & Peacock, London

June 2012 – November 2018
Managing director
Redington, London

September 2010 – March 2012
Cross asset trader
Deutsche Bank, Australia

February 2009 – July 2010
Quantitative analyst
Global Trading Strategies Investment Management, Australia

January 2008 – December 2008
Quantitative analyst
Macquarie, Australia

September 2003 – December 2007
Associate
Mercer (Investment Consulting)
London

What has been the biggest lesson you have learned during your career?

I have written a number of blogs and articles throughout my consultancy career which addresses that question.

The first is I have learned that good writers are good thinkers. When I write something it is not necessarily for people to read, it is great that they do, but more that it helps me order my thoughts.

Second, everything comes down to people. Everything is a people issue.

The third is a beautiful line I read that your personal experience makes up 0.001% of what has ever happened but explains 80% of how you see the world. Which is such an important insight to remember about how you believe the world works.

GREY SWANS: THE GATHERING STORM

At a time of heightened geopolitical risk, *Andrew Holt* asks if investors should prepare for rare but damaging market events?

Grey is the new black. Since former options trader turned professor Nassim Nicholas Taleb published a book on black swans in 2007, investors have been on their guard against events that have a severe impact on the markets and are said to be difficult to predict. But there is now another swan on the block to colour the outlook of events: grey swans.

The precise definition of a grey swan has been debated – making it grey in more ways than one. But generally, they are high impact events that have little chance of occurring.

"A grey swan is a low probability event, yet one that carries risk with potentially broad investment implications, albeit not necessarily all negative," says Lori Heinel, global chief investment officer at State Street.

A slight variation is offered by Catherine Doyle, investment specialist at Newton Investment Management. "Grey swans are possible, but unknown events, which slightly shifts the emphasis," she says. It is a difference in nuance, but still points to events that investors should be trying to identify and do something to address the risk they create.

Richard Tomlinson, LPPI's chief investment officer, offers his own take on a grey swan in percentage terms. "It's not close to zero probability, more like a one in 20 event," he says.

Emiel van den Heiligenberg, head of asset allocation at Legal & General Investment Management, weighs in with his own interpretation. "Grey swans should be conceivably possible, if not necessarily probable," he says. "They typically fall into the camps of geopolitics or macro financial markets but can be more left field."

Risk aware

Grey swans do not exist in a philosophical vacuum. Heinel notes that thinking about them can help investors consider alternative scenarios. "It is something of a given, but the future is always uncertain," she says, yet adds that thinking about scenarios which diverge from a "base case" helps inform the "risk-aware approaches investors can apply across their portfolios".

Heiligenberg also highlights why grey swans are relevant to investors. "Market pricing reflects the probability weighted average of different scenarios, including tail risks. Investors often have a base case but should prepare for multiple scenarios," he says. And the challenge for investors is that grey swans can come in multiple forms.

LGIM's mantra, therefore, Heiligenberg adds, is an interesting perspective on the multiple scenario perspective: 'prepare, don't predict'.

"Thinking about grey swans is all about considering what is possible, even though it isn't probable," he says. "This helps us to identify signposts, to anticipate a scenario sooner or better than most or consider hedges, for outcomes that are particularly detrimental for investors."

"

The challenge for investors is that grey swans can come in multiple forms.

Emiel van den Heiligenberg,
Legal & General Investment Management

Doyle agrees, that, as a thematic house exploring investment themes and how they play out is a given for Newton. "We talk all the time about the risks and opportunities in markets," she says. "We are always identifying opportunities and risk, with grey swans coming under the risk category. But we are always looking at both sides: the opportunities and risks."

In the context of portfolio management, Doyle says that it is around translating into how your portfolio is positioned to deal with such events. "It may translate into avoiding a particular asset class," she says. "The reality is that there are a whole range of events that we are already aware of like some of the wars bubbling away at the moment, which are risks, and could morph into something more worrying," Doyle adds.

Different horizons

Tomlinson's fund is looking at potential grey swan scenarios in two ways currently. "We are looking at the geopolitical situation – as near horizon scenarios – and climate and related challenges at longer-term horizons," he says. "My feeling is the timeline for grey swan risks in the climate nexus is over a five to 10 year horizon."

The shorter-term horizon grey swan assessment is focused on topics familiar with the current environment. "These are around the geopolitics, the escalation of war in the Middle East, oil prices and inflation, with the latter possibly getting a nudge upwards in the grey swan scenario."

Heinel says that geopolitics is a central point of focus when thinking about grey swans. "With escalating geopolitical tensions, major elections and monetary policy reaching a critical juncture, the year ahead will be challenging for investors. 2024 will require agility to respond to market signals and multiple factors within the macro-economic environment," she says.

She therefore points to "pockets of opportunity can be found in equities," but considers fixed income offering better opportunities "given current rates and our expected path of growth and future rates".

On this level, fixed income is one of the best-positioned asset classes from a risk/reward standpoint – in particular sovereign fixed income – US treasuries specifically – may be an attractive proposition, especially over the medium term.

Election time

Digging deeper, where do we search for specific grey swans? One good place is the not so small matter of politics. This is a big election year across the globe. Indeed, most of the world's population – more than four billion people – will be stepping inside a poll booth at different times throughout the year.

There are though three election grey swans hidden in plain sight. In the UK there is going to be an election, with the expectation that Rishi Sunak will announce it will take place in the Autumn.

There is a problem here which leads to the first potential election grey swan. Sunak will have to survive the expected severe fallout from local elections, which will take place on 2 May. Within this scenario it is possible that the results are so awful that he is forced out by unhappy Tory MPs.

It would be a case of deja vu all over again for the Conservative Party. This could result in complete turmoil – would a new leader have a mandate to lead? Would an election be forced? And what would the impact be on the markets?

A worst case market scenario could see the turmoil unleashed by Liz Truss' premiership seem like a quiet weekend in the City. Meaning in short – investors would be best to avoid UK stocks and bonds. Such a move could escalate a deteriorating market situation.

"What would happen to sterling?" asks Tomlinson, when discussing such a grey swan scenario. "Gilts could struggle, or yields spike materially again," he adds.

But Doyle is not sure it would come to that, although she wouldn't rule it out. "There is, however, an awareness among Conservatives to provide stability as the population has been subjected to a lot of change and they in fact want to portray stability," Doyle says.

Tomlinson adds another scenario to the mix. "The Labour Party also faces challenges, given the questions Keir Starmer faces on the Hamas-Israel situation and he was at the CPS when the Post Office prosecutions were going on." This grey swan could leave both main parties in potential paralysis, which would leave the country and markets in a parlous state.

Yes, Mr President?

And who could possibly forget that it is election year in the US. Here, the grey swan scenario is that Biden and Trump don't make it to the final contest. With the big risk scenario that the courts stop Trump from running.

This is already playing out in Colorado and Maine, but the picture could get complex depending how the Democrats play it throughout 2024. The central point is American democracy could well come under considerable pressure, and with it a market upheaval.

In addition, there could be close results in swing states leaving the whole election in a state of limbo: with a scenario that sees lawyers and judges going as far as picking the next president.

Neither candidate making it on the ballot would have serious repercussions. "You probably will see a lot of social unrest," Doyle says. "You could even see an independent candidate coming in – but that would make it more of a black swan," she adds.

Tomlinson also says the scenario is a worry. "It is the idea of America being at war with itself which is concerning on so many levels." For him, the election nightmare scenario leads back to deep geopolitical repercussions.

"The issue would have international implications, because I suspect the US would trundle through, but it may encourage other actors to pitch themselves internationally, maybe Iran, because the US could be perceived as weakened," he says.

We live in a world of not just black swans but multitudes of grey swans and you need flexibility to shift focus and repurpose the portfolio if facts change.

Catherine Doyle, Newton Investment Management

Great tensions

Doyle also puts forward an interesting grey swan. "Although in the UK we talk about Trump winning the election, in the US they are not giving much credence to it," she says.

Her central point as a grey swan is that Trump's election victory would have implications for geopolitical tensions, but also creates investment opportunities. "It is hard to predict exactly how that would play out, but we know Trump has certain leanings towards US manufacturing, which would give this sector a boost from an investor perspective."

Doyle says this can be developed as a convincing grey swan especially when you consider Trump's first term and the playbook he followed. Although she adds: "There would be other investments that would become vulnerable, such those in Mexico, as the border issue would be a big point of focus making Mexico investments vulnerable."

Lastly on the grey swan election radar is the Netherlands. This year the country will decide whether to appoint the right wing Geert Wilders as prime minister after he clearly won first place in November's general election. Whatever happens, if Wilders is appointed leader, or kept out by the political establishment, it is likely to have wider implication throughout Europe's markets.

Some investors have noted that this would create a lot of instability in Europe. "It would play out as a nightmare for the EU. It could feel like EU fragmentation," says one investor. "It would increase the risk premium for Europe. We could have spreads widening in bonds," the investor adds.

Tomlinson finds this interesting. "There is a bigger theme here that we need to keep an eye on: the development of reductionist thinking, the 'if you are not with us, you are against us' line. This is likely to have further implications for other grey swans."

> **It is the idea of America being at war with itself which is concerning on so many levels.**
>
> Richard Tomlinson, LPPI

Conflict everywhere

But for many grey swan scenarios it is likely to come back to one issue: the escalation of geopolitical conflict, which present a key risk for investors. In 2024, the shifting geopolitical landscape – from uncertainty around international and trade relations, conflicts and, as noted, the ability of upcoming elections to reshape the outlook – all deserve close monitoring and agility in portfolio positioning. "For 2024 – unfortunately, but inevitably – a significant number of grey swans are in the geopolitical arena," Heiligenberg says.

On this level, and probably top of the list, is the possibility of greater escalation in the Middle East with Iran entering the Israel-Hamas war.

"That would increase the political-risk premium of the oil price," Doyle says. "Geopolitical shocks are mostly felt by commodities, and the oil price in this instance. So having exposure to traditional energy stocks would mean exiting those in this scenario."

Within the grey swan geopolitical arena at some point China has to come into full focus. Expanding on this, Doyle does not let us down, highlighting China blockading Taiwan as a grey swan scenario.

"This would lead to supply-chain issues, particularly for semiconductors. That would be negative for tech," she says.

"It would not happen overnight, but it will catch-up with portfolio managers. The magnificent seven stocks have been dominating market returns, but if you get this grey swan event investors will have to re-think the type of tech exposure they have."

Another grey swan involving China is something of a reversal of the current muted investor approach to China.

"If we were to see China recover strongly – which is not priced into markets, as everyone is still bearish – it could be categorised as a grey swan, because investors don't think it is going to happen," Doyle says.

The point being that investors seem to have written off China. "But the domestic data is improving," Doyle says. "We are seeing a pickup across Asian trade. So it is not inconceivable that we see a strong recovery in China."

So how should investors approach this grey swan? "There are plenty of ways you can play China, by playing into China demand that would be an opportunity by increasing investor positions in areas such as commodities and industrials," Doyle says.

The inflation swan

Then there is the more standard economic outlook. Inevitably,

With escalating geopolitical tensions, major elections and monetary policy reaching a critical juncture, the year ahead will be challenging for investors.

Lori Heinel, State Street

the inflation scenario rears its head. Doyle says one grey swan could be that inflation does not prove transitory. "At the moment you have markets discounting the Goldilocks scenario and that inflation will go back in its box," she says.

But if inflation spikes that would be something of a shock to the market. "That is not being priced in," Doyle says. "It would therefore necessitate a portfolio with some in-built hedges, in terms of holding real assets and some alternatives linked to inflation. So you can insulate the portfolio to some extent."

But what of those portfolios that lack these?

"Well, it would be a case of emphasising certain parts of the portfolio. We have a bias towards equities and the pricing power enables to pass through the costs," Doyle says.

"So we might look to increase our equities, shy away from holding bonds, as an inflationary environment is not good for bonds, and increase alternatives, especially the inflation linked ones. We would also, potentially up the gold exposure, as an inflation hedge," she adds.

Heiligenberg also has an interesting grey swan insight on the macro financial picture.

"In a higher rate environment, there's the possibility of a large leveraged player – such as a bank, insurer, hedge fund or corporation – getting into trouble, triggering a flight to quality," he says.

"These events may not be our base case scenario, but it's important as investors that we consider the full range of possibilities and prepare accordingly."

Deficit debacle

In the US economic context, there is a potential grey swan where pressure is brought to bear on the US deficit. "There is a lot of talk of a dry up in treasury-backed products and this could have unintended consequences on the bond market," Doyle says. "Bonds are, after all, the plumbing of global markets."

One of the biggest issues being addressed and discussed in financial markets is that of artificial intelligence (AI). Investment researcher Macro Hive has come up with an interesting grey swan on this much-debated topic.

Macro Hive's Karl Massey places a grey swan at the heart of the investment world, as it is shocked by an expose that an AI model has been manipulating global financial markets for the past six months.

Possibly a little more sci-fi than grey swan, this could trigger chaos among investors, leading to a collapse in equities, commodities, high-yield bonds, real estate and currencies.

Regulators would then step in suspending the affected markets, creating its own potential chaos in the process. Whether this is likely, is a moot point, but the issue that AI may be a grey swan hidden in plain sight is surely a valid one.

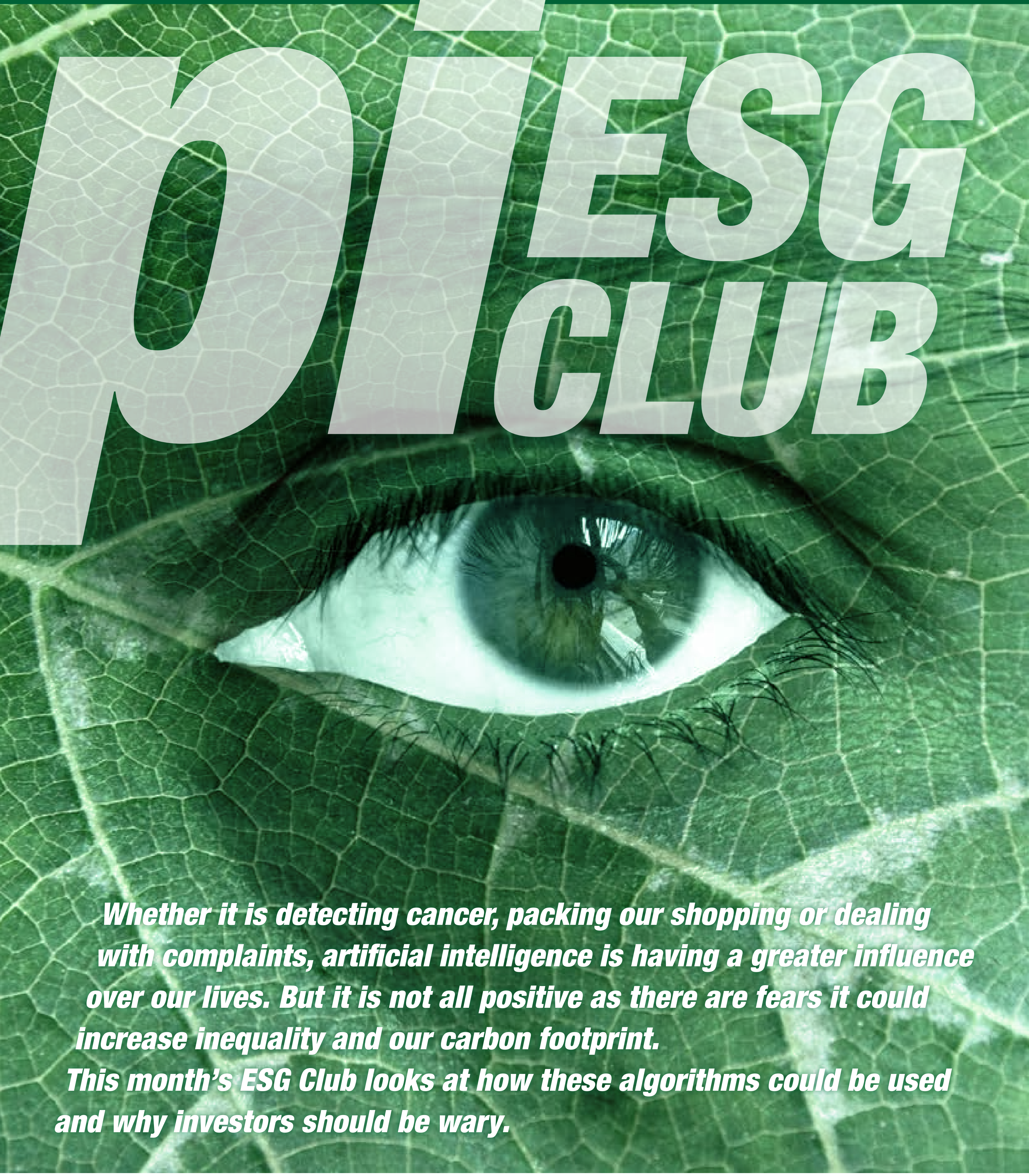
Offering a lighter note on grey swans this year, Heiligenberg says: "I am Dutch, so it would be remiss of me not to mention a grey swan for 2024: for the Netherlands to win the Euros this year." Now which investors are willing to embrace the risk connected to taking a punt on that?

Addressing grey swans

Tomlinson in turn has advice on how investors can deal with the precarious nature of grey swans. "To address grey swans you try to build a portfolio that performs in expected central cases survives a broad range of stresses and downside scenarios," he says. "To do that you bring together the probable scenarios and then assess: what if that happens, and how you should deal with it."

All of these scenarios point to one thing, Doyle believes. "That is to have flexibility and a nimble investment approach which is fundamental for the years ahead," she says. "We live in a world of not just black swans but multitudes of grey swans and you need flexibility to shift focus and repurpose the portfolio if facts change."

To extend this further, and to use a boxing analogy, in dealing with grey swans effectively, investors need to learn an Ali shuffle. They can then box out of a tricky situation when they are well and truly on the ropes.



pi ESG CLUB

Whether it is detecting cancer, packing our shopping or dealing with complaints, artificial intelligence is having a greater influence over our lives. But it is not all positive as there are fears it could increase inequality and our carbon footprint.

This month's ESG Club looks at how these algorithms could be used and why investors should be wary.

Members

BlackRock. BNP PARIBAS ASSET MANAGEMENT LGIM NEWTON Investment Management PENSIONS AND LIFETIME SAVINGS ASSOCIATION

ASSET MANAGERS UNDER FIRE FOR NOT VOTING ON ESG RESOLUTIONS

Managers hit back on accusations of dire voting performance. *Andrew Holt* reports.

When it comes to environmental, social and governance (ESG) commitments, asset managers occasionally find themselves in the firing line.

But the latest criticism from campaigner Share Action accuses larger firms of turning their back on their ESG commitments following their worst voting performance yet.

Research from the responsible investment pressure group found that in 2023 only 3% of assessed resolutions were passed, down from 21% in 2021.

Of the environmental resolutions assessed, just 3% passed last year compared to 32% in 2021. On social resolutions, a drop in majority support from 15% to 4% over the period was revealed.

Furthermore, many asset managers are risking accusations of greenwashing by not supporting crucial climate resolutions despite having net-zero pledges, Share Action said.

The group noted that asset managers who have signed up to Climate Action 100+ with a mandate to protect the environment "are at the same time voting down resolutions at AGMs that would improve environmental protections in what can only be described as greenwashing".

Claudia Gray, head of financial sector research at Share Action, said this is the worst result she has seen from asset managers in recent years. "This lack of support for key shareholder resolutions in 2023 is deeply concerning," she added.

"It is even more worrying that some of the world's largest asset managers are failing to support climate resolutions despite their public commitments to reduce carbon emissions," Gray said.

For asset managers to have any credibility here "they need to vote in favour of more social and environmental resolutions", she said, but added that the opposite is happening.

Ranking 69 of the world's largest asset managers, Share Action's research assessed how they voted at AGMs during 2023, and for the first time makes a comparison with the policies and public statements of the asset managers.

Geographic differences

The research also uncovered a distinction between the way European and North American asset managers voted in 2023.

Asset managers in European have a much better record of voting for resolutions that are designed to protect the environment and human/employee rights, than their US counterparts.

Share Action revealed the trend toward more responsible voting practices among European asset managers continues unabated.

On average, they supported 88% of shareholder proposals on environmental and social issues, signalling a positive trajectory across European countries.

In the UK, support hovers at around 64% on average, while US asset managers typically only voted for 25%.

The research highlights that Blackrock, Fidelity, Vanguard and State Street, known as the 'big four' asset managers as they are the largest in the world, "have a massive influence on the companies they invest in".

Yet average support amongst the big four for environmental resolutions fell from 39% to 14% between 2021 and 2023, according to Share Action.

Support for social resolutions went down to 13% from 29%.

A resolution at Amazon calling for an assessment of its workers' union rights would have passed had the big four voted in favour, along with 68 other key resolutions, said the responsible investment pressure group.

Share Action also suggested that dozens of resolutions would have passed if these managers had voted for them, including at Amazon, Apple, Coca-Cola, chemical giant Dow, Pfizer and Lockheed Martin.

Long-term return

Share Action said the world's largest manager, Blackrock, supported just 8% of resolutions.

But in response, a spokesperson for Blackrock told *portfolio institutional*: "As a minority shareholder on behalf of our clients, our role is to better understand how company leadership is managing risks and capitalising on opportunities to deliver long-term financial returns. We analyse each resolution on a case-by-case basis and vote, where authorised, to advance our clients' long-term financial interests."

The spokesperson also gave context to why the asset manager had voted as it did.

"In 2023, because so many proposals were over-reaching, lacking economic merit, or simply redundant, they were unlikely to help promote long-term shareholder value and received less support from shareholders, including Blackrock, than in years past."

A spokesperson for State Street also explained its voting approach to *portfolio institutional*: "At State Street Global Advisors, we have maintained a consistent voting record on environmental, social and governance shareholder proposals.

"We support proposals we think make sense for a company while not being overly prescriptive or dictating how management runs a company. This approach is the best way to build long-term shareholder value for our investors."

ESG INTERVIEW – HONOR FELL

"Positioning the fund to prosper in a future net-zero economy is the key pillar that we have to achieve."

The sustainable investment officer at the Cambridge University Endowment Fund tells *Andrew Holt* about the issues she has with some asset managers, investing for the next 800 years and being comfortable about being uncomfortable.

How important are sustainable investing and ESG to the Cambridge University Endowment Fund?

We are focused on sustainability. The purpose of the endowment is to deliver world-class sustainable investment performance. It comes down to our purpose as an organisation, which is to deliver income in a way that is sustainable.

We specifically talk about a sustainable economy as one that is well governed from an environmental and social perspective for the long term.

We are focused on sustainability, rather than just the ESG label. It is our purpose and mission, but it is also important for the university and our wider stakeholders.

So sustainable investment is baked into everything you do?

It is central to everything we do. We do not have a sustainability or impact investment bucket. We have a sustainable investment strategy across all asset classes and all of our activities. It is fully integrated into all of our investments.

What has the endowment invested in?

The fund has a dedicated team of 18 people and we invest across asset classes globally, but through asset managers. Everything we do is through third-party managers. We have no direct investments.

Sustainability needs to be part of the interaction when we select a new [asset manager] partner, to make sure they are aligned with our sustainability goals, in particular, climate change. We then monitor how they put those sustainable policies into practice. We are up front with managers about this.

Analysis has highlighted a disconnect between asset owners and asset managers when it comes to sustainability, with asset managers being somewhat off the pace on the issue. Is that your experience?

We rate all our mangers on sustainability, in terms of good governance, their policies and processes, what they do in the portfolio and implementation.

In our portfolio we have asset managers who are doing a fantastic job and asset managers where we have identified areas for improvement. We make sure every time we make an investment we see evidence among the senior management investment team that they are aligned with our vision around sustainability.

European managers are more forward thinking and advanced in terms of sustainable investment and decarbonisation. There is more work to do with US-based managers. It is though not a hard and fast rule.

We typically work with small, boutique-type managers as well.

One thing we have done, which is quite unique, is to create an executive education course, in partnership with The Cambridge Institute for Sustainability Leadership, which we encourage our partners to attend.

What are your asset managers failing on?

A common issue is that sometimes they do not apply the sustainability policy consistently. We may see them being great in some areas or with some companies, but this is not applied elsewhere.

We hold a lot of data on high emitters and ask an asset manager why they are holding such a company. The asset manager may reply that they have different data to us. We then dig into it together and the asset manager engages with the company on this specific issue.

The other failing is not fully explaining to us what they do and how they approach it.

What is your net-zero strategy?

Climate change within the sustainability investment policy is key. Positioning the fund to prosper in a future net-zero economy is the key pillar that we have to achieve. The headline is an ambition for the fund to be net zero of greenhouse gas emissions by 2038.

One of our commitments is reducing fossil fuels as soon as possible, or by 2030, and to look for investments in renewable energy to build a low-carbon economy. We have found some interesting investment opportunities there.

We have three implementation pillars, which are investing for net zero, engaging to drive the transition and reporting back with transparency and accountability to our stakeholders.

How do you keep all of your stakeholders happy with your sustainable investment strategy and net-zero ambitions?

Our team came into place after 2020 and it was at that point we put the current strategy in place. So it is just over three years old. We did a huge amount of engagement with stakeholders at that point, so had a lot of input into it.

A key part of our ongoing strategy is engaging with our stakeholders in a variety of formats: through our website, annual reports, town hall meetings and a governance body that represents the stakeholders.

What has been the biggest challenge your fund has faced from a sustainability investment perspective?

The biggest challenge of our model is that we invest with third-party fund managers, so from that perspective there is a level of disintermediation. And if we are engaging with a manager it can take time for changes to be made, which can be a challenge with pooled vehicles.

Within those pooled investments have you had any sustainable investment surprises?

We haven't had any real issues within the portfolio. But what I would say is when you go through all the different language fund managers use to describe what they do, different organisations use different definitions. So we need to be cognizant of the fact that our definition may not be the same as everyone else.

Is that a big problem around those different definitions?

It is a huge challenge. You could get paralysed by the diversity of definitions and metrics. You also have some managers labelling stuff that may not be 100% correlated to what they are doing.

You have said that the requirement to deal with hard to abate sectors is an urgent responsibility. What have been your conclusions on this?

One of the issues is nearly a third of global emissions are from the steel, cement and aviation sectors. So far, there is not enough investment here to support the transition. The tendency has been to focus on electrification and renewable power. So there remain difficult technologies and sectors that need investment to decarbonise.

Sitting alongside that is the discussion we are having around the labelling of funds, reporting on funds and trying to set targets and incentives for fund managers to encourage and attract progress on sustainability ambitions.

But there is the potential that if we just focus on the total emissions picture to go down in a straight line, we may not be able to get investment for these high emitting sectors and to create the technologies that we need to put in place.

I don't have a great conclusion yet, but it is important for us to invest with asset managers who are investing in technologies to decarbonise in these areas in order to be part of the transition. We should not walk away from this area just for our portfolio to have a low emissions profile.

We need to be careful that as an industry we don't conflate tech funds with low emissions with a great impact on decarbonising the economy.

Will supranational events help or hold back your sustainable investment work?

National and supranational policies and frameworks are critically important. They have to happen. And they have to keep moving forward for us to have an investment universe of companies. Having said that, for us, the real high impact work is working with our fund managers.

> **We are focused on sustainability, rather than just the ESG label.**

What would you change to beef up global co-operation on sustainable investment?

It is the point about consistency and co-ordination so that we can have global standards, which is happening with The Task Force on Climate-Related Financial Disclosures.

What is the biggest difference between your endowment and other institutional investors when it comes to sustainable investment?

There are quite a few things. We have an incredible long-term time horizon and don't have liabilities in the same way as a pension fund does. Our investment has provided for the university and is more than 800 years old. And although we will all be dead, hopefully the endowment will support the activities of the university in another 800 years. So we are an institution that is incredibly long term.

Our allocation is therefore different to, for instance, a closed DB pension scheme. We have a high target allocation in equities, at 60%. Of that, the long-term target for private equity is 30%. So we have a high percentage of private assets and equities and our private market managers have the tools to drive sustainability in companies for the long term.

Then we have access to the university and its research, not just on climate issues, but in all fields. That is pretty unique.

That is sharing some of the scientific and research knowledge on climate change with our asset managers and gets them in that space where they can talk about what they can do and what their tools are as investors to drive the transition to a low-carbon economy. We have a bespoke executive education programme, completed by 18 firms, managing more than £150bn. That has helped to magnify our impact.

We are also a nice size with our net asset value being just over £4bn. We are big enough to have a good team to invest globally, but small enough to invest with early stage managers or managers who have capacity-constrained funds but are pretty nimble. That is quite exciting in that it helps us to build a strong portfolio.

What are your hopes for the fund and the wider sustainable investment industry?

In the long term, what would be great to see happen in the industry is for sustainable investment to be the core part of all investment. Not something that is seen as separate. That is the key hope.

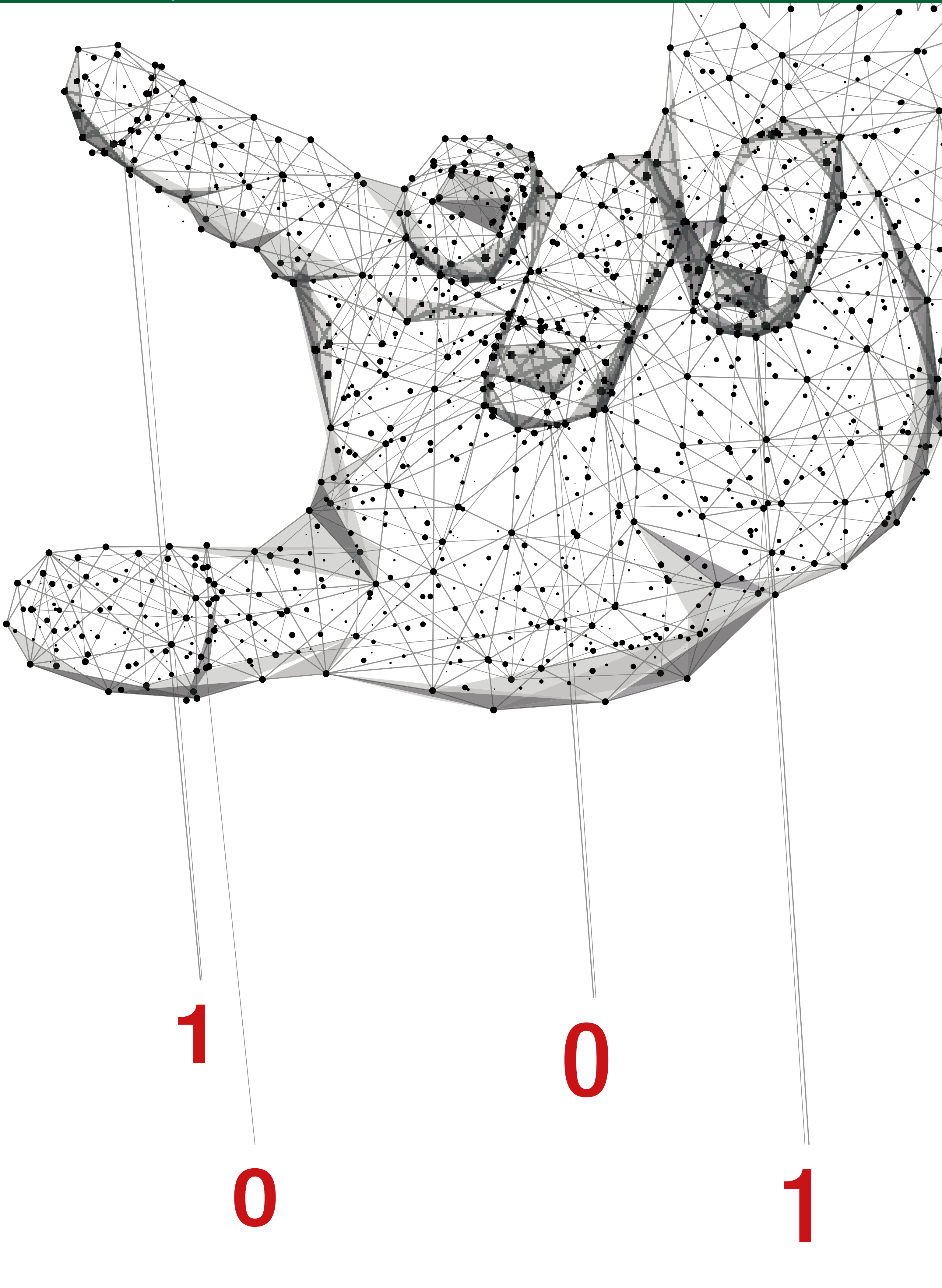
For us as a fund, it is to be recognised as one of the asset owners that have been part of that important journey of sustainability being integral.

How far away are we from that?

We still have a lot of work to do. I don't know how far away we are. There has though been a huge positive with the direction of travel in the last five years. And there is strong momentum, but we don't see that being applied equally.

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

Not feeling paralysed by a lack of information. Taking what is in front of you and then making a decision. So being comfortable about being a little uncomfortable in making progress on climate ambitions and to think differently.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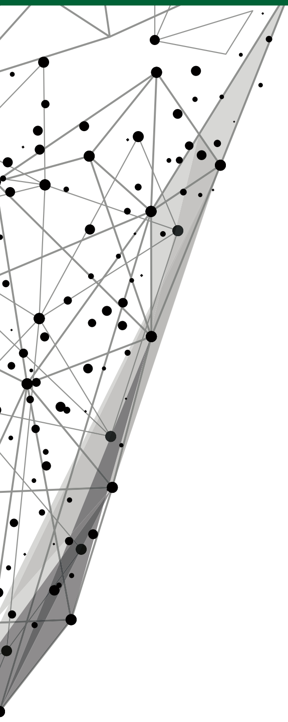


ARTIFICIAL INTELLIGENCE: ARE FRIENDS SYNTHETIC?

Algorithms are changing the world, but will they help or hinder efforts to make society greener and fairer? *Mark Dunne* takes a look.

We are living in revolutionary times. Artificial intelligence (AI) is influencing our lives in a way that can only be compared to the transformational impact of the industrial revolution, or the inventions of the steam train, car, telephone and internet.

Computer systems that are designed to think like people are becoming more prevalent in society. Being programmed to learn, reason and problem solve means these AI algorithms can perform tasks that only people were once considered capable of doing, such as driving cars, dealing with customer complaints, recommending TV shows, translating text into different languages and even writing songs.

These algorithms, the most famous of which is ChatGPT, have the potential to enhance and improve all areas of society, from our personal lives to the commercial world, the military, healthcare and science.

For example, it can automate tasks such as processing invoices and packing customer orders faster in retail warehouses. They can help scientists make new discoveries and answer students' questions in the classroom.

You could argue that as these algorithms are being developed to be smarter versions of the people who created them, they could have a bigger impact on society than industrialisation, the opening of the first commercial oil well and perhaps even the discovery of fire.

Demand for such services is high. Indeed, AI is worth more than India and China's combined GDP at $15.7trn (£12.3trn), PwC believes. Around half of this ($6.6trn) is expected to be generated by improved productivity, with the remainder from consumption.

> **From my discussions with our managers, [AI] is going to be a massive game changer.**
>
> Jennifer Devine, Wiltshire Pension Fund

Hot chips

To understand the strength of AI's growth, we have to look at Nvidia, which makes chips for the applications algorithms run on. Its sales reached $18.1bn (£14bn) in the three months to the end of September – $12bn (£9.4bn) more than in the same period a year earlier. Analysis have been quoted as estimating that in the next two years, its revenues could break $60bn per annum.

"From my discussions with our managers, [AI] is going to be a massive game changer," says Jennifer Devine, who is head of pensions at the Wiltshire Pension Fund. "They describe it as a paradigm shift.

"It is going to be a big deal and that is why we are taking a look at it. But we don't know anywhere near as much as we would like to know at this stage in the game. There is just so much to talk about, whether it is a good thing or a bad thing.

"We have all seen Nvidia's stock performance rocket and felt that we needed to dig a little bit deeper to explore some of the wider implications," she adds.

But while AI offers the potential for great rewards, the potential risks are equally as high, if not greater. Putting machines in charge of our lives only for them to turn on us with often fatal consequences is the theme of many science fiction stories.

One example is Arthur C Clarke's 1968 novel *2001: A Space Odyssey*, where putting a computer in charge of a spaceship turned into a life-and-death battle for the crew. The computer attempted various methods to kill them after they tried to disconnect the system on fears that it was malfunctioning. The computer uncovered the plot by lip reading a conversation.

Then there are the Terminator films, where the US government putting a self-aware computer in charge of its defence system turned the world into a nuclear battlefield after identifying humanity as a threat.

So is the world ready for such disruption to our lives and the power that is now in the hands of corporates and governments?

Another issue is that with many institutional investors focused on building a sustainable, renewable and a more equal world, can AI be used to achieve such an aim, or will it cause job losses and emit more harmful gases into the atmosphere?

Show me the honey

For the Wiltshire Pension Fund, the impact of AI is largely being felt in its portfolio. "A lot of the stocks we have in our sustainable portfolio might end up being affected by [AI]," Devine says. "There is more tech in there and forward-thinking solutions stocks, so we could end up seeing more of the implications of it."

However, at this point Devine is not sure how AI could benefit the fund's sustainable investing process but believes that it could help in assessing data. "We have a world of climate data and it takes our analysts quite a lot of manpower to plough through that," she adds.

So crunching the numbers could be the main benefit of using AI to ensure better sustainable investment decisions.

Savings bees from possible extinction is one such use for a system that can process huge amounts of data. Bees are crucial to our life support system, yet their numbers are falling at a time when we need to produce more food to feed growing populations.

The World Bee Project is an initiative that uses artificial intelligence to try and help bees live longer. They gather information on their habits from sensors, microphones and cameras. That data is then analysed by an algorithm to spot any trends that could help science intervene to increase their chances of survival.

Another way to produce more food sustainably is to use the analysis AI can provide to maximise output through nurturing seeds and knowing the perfect time to harvest crops. Data could also be used to identify failing crops or spotting the early stages of a drought.

Devine highlights the role tractor-maker John Deere is playing here. The company is using AI to reduce the use of the pesticides that are harming soil. It is using drones to identify weeds so farmers can then specifically target them with pesticides. "That is an environmentally progressive development that it has made as a company," she adds.

The machine will see you now

The research side of medicine is one area that will benefit from AI, without scores of jobs being made redundant.

It could, for example, research a disease to predict its development and therefore allow doctors to diagnose it earlier. Back in 2021, a team of Mount Sinai medical researchers created an algorithm that predicts the development of diseases, including cancer. The team reported a 94% success rate.

Then there is making life easier for people living with disabilities. Huawei, the multi-national Chinese tech giant, used AI to create StorySign, an app that translates text into sign language to help deaf children learn.

The company also created Track AI, a device that can identify visual disorders in children in the hope of being able to treat problems to avoid sight loss. Again, AI is being used to help diagnose medical conditions earlier to help prevent long-term conditions.

More time to play?

One of the outcomes of AI is automation. It started with barriers in car parks, coffee vending machines, factory production lines and ATMs, but thanks to AI automation is rapidly spreading to other industries. Education is one such example, where students are learning more online, even in the classroom, where the system can answer their questions and mark their work.

Jobs in finance, the clerical side of the legal profession, coding, graphic design, administration and problem solving in engineering are also at risk of disappearing. Indeed, more than 300 million full-time jobs around the world are at risk from AI, according to Goldman Sachs. A report published by the investment bank on the issue concluded that some two-thirds of jobs around the world are exposed to automation, while AI could take over a quarter of all tasks in the workplace.

So more AI leads to greater automation, which points to fewer jobs in the economy as people are replaced by machines. Unless new jobs are created and retraining is provided, then inequality in society is only likely to grow.

Christopher Moore, an investment team lead at the Wiltshire Pension Fund, says people are not quite sure what impact AI is going to have in some sectors yet. "But the likely expectation is job losses or job changes," he adds.

For Devine, this highlights the need for stakeholder engagement when it comes to AI. "It is a theme that needs to be looked at, particularly from the social aspect of people losing their jobs or not being retrained."

But one person was not worried about the impact of growing automation. Arthur C Clarke said that he did not fear automation because "the goal of the future is full unemployment, so we can play". But he was an anti-capitalist, so perhaps he gave little thought to who is paying for billions of people around the world to "play" instead of finding a way to pay the rent.

But there are not just social side effects of the rise of AI to consider. One of the winners of the AI boom is expected to be data centres. More computer algorithms mean a greater number of data centres having to supply more power to support them, which means creating a larger carbon footprint.

Research carried out by a team at Cornell University looked at the environmental impact of machine learning and found that the process can emit more than 50 tonnes of carbon dioxide, which is 25% more than a typical car driving on the highways and roads of the United States.

A brave new world?

Don't worry. Artificial intelligence may not turn us into slaves or kill us after deciding that we are a threat to the world. We have to put our confidence in the designers that they are factoring security measures into their systems to avoid such outcomes. But AI will make our lives almost unrecognisable in the next 10 years. Working practices will change and some jobs will disappear, while others may be created.

There are bigger concerns. Will these algorithms help the world transition to cleaner sources of energy, produce more food more sustainably and create a more equality in society? Well, it will certainly benefit medical science and help investors digest reams of data faster, which could improve outcomes.

But as more algorithms are created, there will be a greater need for power to fuel them. This will only increase the level of carbon being expelled into the atmosphere, while the social challenges of more jobs being eradicated than created will lead to the gap between those who have and those who don't growing wider.

So many of the world's citizens may not be so happy just playing all day, as Mr Clarke was hoping he would end his days.

ENTERING THE AGE OF ARTIFICIAL INTELLIGENCE

Technological advances have a long track record of effecting profound change in the way we live, work and play. However, artificial intelligence (AI) hails the prospect of transforming disruptive tech.

AI's disruptive potential is generating huge excitement across financial markets, while also raising questions about its wide-ranging risks. For investors, AI is becoming a trend that we can't afford to ignore, but sifting beyond the hype to uncover genuine, long-term opportunities won't be straightforward.

AI's disruptive potential is generating huge excitement across financial markets, while also raising questions about its wide-ranging risks. For investors, AI is becoming a trend that we can't afford to ignore, but sifting beyond the hype to uncover genuine, long-term opportunities won't be straightforward.

Accelerating the AI evolution

More than a feature of science fiction, AI has been a scientific reality since the 1950s, but its integration into our world has been relatively sedate until now.

Artificial intelligence is a technological advance in its own right. More importantly, it is an enabler that a whole spectrum of players can harness to build new products and services. The technology's 'generativity' – its capacity to produce unanticipated changes – is already bringing rapid advances and significant disruption across industries.

As a result, we are on the verge of series of technological revolutions in various sectors – and as we know from previous such revolutions, that means a period of creative destruction, with change happening quickly, existing players being outpaced by new challengers, and new solutions to old problems emerging at pace.

This effect was seen in a microcosm with the launch of OpenAI's ChatGPT, which apparently came from nowhere to become one of the fastest-growing consumer technologies of all time, leaving previously unassailable tech giants scrambling to keep up. While still in its infancy, this technology already offers a breadth of usages – from writing text to summarising data or even assisting developers with generating code.

A key differentiator from previous AI systems, generative AI can produce content that flows in a natural, human-like way and has been used to produce credible poetry and songs. And this is just the start. It has evolved beyond text to generate content in other formats including images, video and audio and has the potential to unlock other new frontiers in innovation and creativity.

A burgeoning AI economy

Unlike prior AI iterations that were the domain of IT specialists, generative AI applications have a much broader utility – almost anyone can use them to communicate and create. Consequently, its adoption is likely to be accelerated to a point of ubiquity, which could add trillions of dollars to the global economy. McKinsey's latest research, for example, estimates that generative AI could add the equivalent of $2.6trn to $4.4trn (£2trn-£3.4trn) annually.

Initially, there will be significant knock-on effects on the wider technology sector. Market-leading software providers are already leveraging the technology in programming and to do augmented coding. Meanwhile, semi-conductor manufacturers are reaping the rewards from the exponential growth in computing resources demanded by evolving generative AI systems.

Yet, the real excitement about AI surrounds the value it can create for businesses beyond the technology sector.

Promising AI applications

As has already been seen with digitalisation, AI has a wide variety of impactful tools that will improve cost efficiencies and unlock new revenue streams across many industries. In fact, the Centre for Economic Policy Research predicts that around 70% of companies will adopt at least one type of AI technology by 2030. According to McKinsey, the areas of most immediate change are likely to be customer service, marketing and sales activities, and research and development, which will in turn impact industries such as banking, retail and life sciences.

For customer services, generative AI chatbots will be used to automate interactions with consumers, improving the speed, quality and effectiveness of automated responses and enabling human agents to spend their time on more complex or value-added activities. The sales process will become more personalised, as AI systems can rapidly process data to identify tailored product suggestions better suited to consumer preferences. Such advances could result in AI virtual shopping assistants recommending clothes based on our sizes and tastes and advising where to buy them; virtual health assistants creating personalised meal plans and workout routines using data collected from our wrist monitors; or even entertainment assistants that generate customised TV viewing plans.

AI has the potential to be the great equaliser in education, erasing distinctions across countries and between state and private education systems. There are widespread applications personalised learning approaches – from helping children who are falling behind to supporting the integration of those arriving in new countries without language skills.

The ability to map, monitor and manage supply chains means AI can drive marked improvements in productivity and efficiency. Firms can use AI technologies for demand forecasting, predictive planning and transport route optimisation. This has implications for vehicle production and for how those vehicles are used. In the future, we could see dramatic changes to the transport system, with autonomous vehicles driven on optimised routes that reduce congestion, allowing people and goods to move around much more quickly and reducing the impact of transport on the environment.

Within life science industries, AI is already being used to accelerate the development of new drugs or to design new therapeutic tools and can be used to predict the efficacy of drugs and speed up testing. Pharmaceutical companies are buying up specialist AI firms, but the winners will be those with the ability to nurture AI capabilities and combine them with manufacturing and implementation expertise. And it is AI's creative capacity that is boosting hopes that it will play an innovative role in ushering in new climate-saving solutions.

New technology creates new risks

Whenever a new technology emerges and gains rapid adoption, there is a risk that some companies will be disrupted or disintermediated, particularly if they don't adapt quickly enough. However, generative AI also presents a swathe of risks around employment and content generation, data security and privacy, energy consumption, and even diversity and inclusion.

Amid all the talk of business optimisation and virtual assistants is a real concern about workforce displacement – estimates from CNBC suggest that two-thirds of jobs may become automated to at least some degree. AI's content-generating skills are also creating consternation in some areas amid the growing spread of misinformation and the misuse of people's voices and physical images.

From an environmental perspective, AI data centres are already responsible for 2% to 3% of global greenhouse gas emissions, per Harvard Business Review, but data volumes are expected to double in size every two years. Digitisation has already been shown to have a problem with impartiality; if not tackled quickly gender and racial biases within AI programs could hinder efforts to enhance diversity, equity and inclusion.

With AI developing at such a rapid pace, it is hard for regulation to keep up although authorities are starting to weigh in on the issue. The upcoming EU Digital Services Act includes provisions for an ethics framework for AI as well as guidelines to help adjudicate AI-related issues; meanwhile, the Algorithmic Accountability Act in the US requires periodic assessments of high-risk AI systems that involve personal information or make automated decisions.

Finally, AI is already exacerbating existing geopolitical tensions, notably the rivalry between the US and China. Both countries are pouring resources into AI, but China's lack of privacy laws may mean it has an edge in the form of huge data sets. Increased protectionism and the desire for digital sovereignty may prevent AI firms from achieving global scale.

AI as a key growth driver

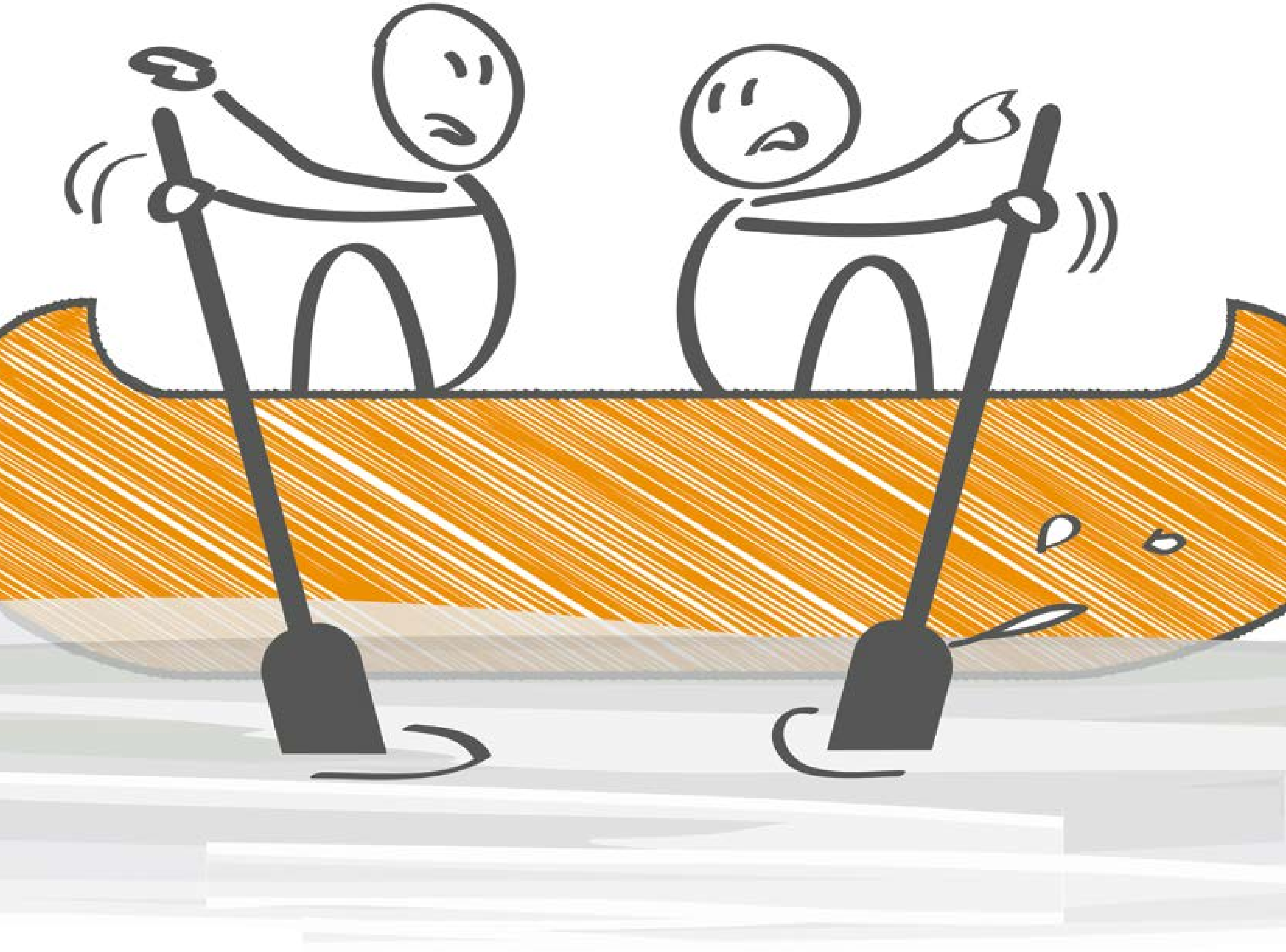
As AI adoption proliferates, there are also risk factors to monitor with respect to fundamental analysis, environmental, social and governance (ESG) factors and investor sentiment.

From a growth perspective, the speed and duration of infrastructure development are uncertain, and there could be pauses for 'digestion' during the process. AI expenditure could crowd out budgets for other information technology projects.

On the ESG front, irresponsible users could abuse AI for surveillance, hacking and the creation of deep fake news. Biased data sets may result in incorrect output from AI models. Other issues include the significant energy requirements for powering the data centres that run AI models.

Avoiding the AI hype

As the age of AI commences, investors should pay close attention to its far-reaching potential. Yet, as previous technological disruptions have taught us, it is easy for investors to get swept up by the latest megatrend, but it is far more challenging to differentiate between who will be the ultimate winners and who will fail to make a lasting impact.



BRICS: HOW NOT TO BUILD AN INVESTMENT BLOC

An increase in membership points to Brics looking at becoming an investment and political bloc to rival the G7. But, as *Andrew Holt* finds, there is a lack of excitement for the idea.

In August last year, Brazil, Russia, India, China and South Africa – collectively known as the Brics group of emerging economies – agreed to admit new members into their club.

Egypt, Ethiopia, Iran, Saudi Arabia and the UAE have since increased the size and influence of the bloc, with Argentina withdrawing its planned entry into the bloc. Collectively, they have established something of a potential financial and political powerhouse: accounting for 47% of the world's population and 37% of global GDP.

Will this group, therefore, as many of its members hope it will, challenge the G7 nations? And more importantly, what will it mean for investors – do these countries look more appealing and stronger than they did as disparate nations?

The investor votes are in, and it looks like nul points for the new-look Brics. "We don't think membership of Brics will elevate the investment attractiveness of these economies," says Michael Langham, emerging markets analyst at Abrdn.

"Only if membership leads to credit lines between members or increased investment to address critical infrastructure needs could this be viewed as generating a more attractive investment proposition," he adds.

Thierry Larose, portfolio manager at Vontobel Asset Management, is equally unimpressed. "From an economic and financial perspective, Brics is far from being relevant as a bloc, with the exception of a few scattered initiatives like the New Development Bank. For investors, this means that Brics members will continue to be assessed on their own."

A weaker proposition

When it comes to assessing the new joiners, the case for Brics gets weaker, not stronger, Larose says. "We believe that they will not change the existing situation.

"Argentina is in the middle of a deep economic crisis and is no longer interested in joining the alliance," he adds. "Egypt and Ethiopia are in a state of quasi bankruptcy. Iran is another pariah state. Saudi Arabia and UAE have neither the incentive nor motivation to cut the economic ties with the West. Their objective is to grow and prepare their transformation for the post-hydrocarbon era."

Put like that, Brics sounds deeply unappealing. Langham also presents a scenario where Brics creates a situation which is opposite of its aims. "If Brics becomes a forum which increases investor perceptions of a fracturing international order, international capital flows could dry up, amplifying domestic challenges and potentially generating a negative feedback loop," he says.

And for Maria Negrete-Gruson, portfolio manager in the sustainable emerging markets team at Artisan Partners, the new Brics breaks the fundamental attraction of the component countries from an investment viewpoint. "Expansion of the Brics framework does not sway our investment perspective, and we believe our sentiment resonates among emerging market investors," she says.

Her point is that a fundamental aspect of emerging markets as an asset class is the diverse exposure to countries in various stages of development. "We believe that any grouping of a select few emerging market nations goes against the concept of diversification, and it will end up harming investors and the broader economic development of emerging markets," she says.

Expanding further, Negrete-Gruson adds: "Brics has become a misguided idea that size is the overriding determinant of emerging market performance."

Great collaboration

But Jason DeVito, lead portfolio manager in emerging markets debt at Federated Hermes, offers a more upbeat picture. "The group's expansion will lead to greater economic collaboration amongst a larger swath of the emerging market world. Longer term, this will provide more bilateral trade flows, technological exchange and less dollar dependency," he says.

This could create a wider variety of investment opportunities in the emerging market space, DeVito says. "We expect enhanced investment opportunities to result from the expanded Brics, and greater opportunities may arise to participate in infrastructure investments which are supported by the wealthier Brics countries in the less wealthy Brics countries," he says.

Here DeVito points to Saudi Arabia and the UAE, which over the past few years have invested heavily in other emerging markets. "Particular areas of focus have been in agriculture, manufacturing and the tech sector, all of which are areas where the oil-rich region has tended to be laggards in," he says.

Langham also highlights how Brics could challenge the G7 countries in investment terms. "Given China, UAE and Saudi Arabia have large reserves and sovereign wealth funds, this could see funding diverted away from G7 economies to Brics members," he says.

But for Langham, more fundamental factors for institutional investors will prevent them from moving capital from the G7 *en masse*. "Fundamental reasons for investment flows into the G7 are the economies' open capital markets and strong institutional quality, which reduce the risk of investing. Brics is unlikely to challenge these fundamentals as a group."

A pariah and a giant

Building on the idea that investing in Brics is risky business, while also giving little credence to Brics as a cohesive bloc, Larose identifies the strengths and weaknesses of its component parts – with a bigger emphasis to be found on the latter.

"Brazil is a commodity powerhouse with chaotic internal politics," he says. "Russia is a pariah state finding itself more dependent than ever on hydrocarbon resources to finance its military-industrial complex," he adds.

"India," Larose says, "is a rising giant that has neither incentive nor motivation to sacrifice its economic ties to the West in order to please its eternal rival China." And China "is a gigantic recycling machine, transforming what they buy from their Brics allies to cater for the West consumption needs".

Adding on China, Larose says: "There is the issue with Taiwan, which could make China the next pariah state." And South Africa he describes "as a social-economic time bomb, where inequalities and an inability to grow never let the nation recover from the dark times of apartheid".

But the problem with Brics doesn't stop with such a gloomy assessment. There are further stumbling blocks in presenting Brics as a new political and investment panacea.

Brics reject

The first issue comes in the form of Javier Milei, the new prime minister of Argentina. His libertarian views mean he looks to the West, not to Brics, as the way forward.

Milei has rejected Brics membership, advocated a dollarisation of the country's finances, albeit something he has not acted upon at the time of writing, but pitching him firmly against the narrative of the Brics. If he persists in this, as seems he will, how much will it undermine the whole Brics power project?

"Milei's rejection of Brics membership shows that the group may struggle to position itself as a voice for the global South," Langham says. "Members have competing geopolitical aims and Brazil, India and South Africa have pushed back on the group being seen as a direct challenge to the West."

But DeVito sees positives for Argentina and Brics from an economic and investment standpoint. "Milei is looking to take a more fiscally responsible and investment-friendly economic approach to managing the Argentinian economy. So, an improved Argentinian economic environment will encourage much needed outside investment in industry and infrastructure," he says.

There can be no doubt that what plays out in Argentina – given the unpredictability of Milei – and its impact on Brics, will be interesting to see.

Democrats and autocrats

The second, and probably more fundamental, reason that Brics will not advance in an upward power trajectory is the uneven political nature of the Brics countries. They range from democracies to autocracies, something which is likely to undermine Brics as an effective investment bloc.

Larose agrees with this premise. "Political contexts and economic conditions are just too heterogeneous to envisage any kind of union at the trade level let alone at the monetary level. The only common denominator those countries have is the will to challenge the leadership, hegemony of the West," he says.

An argument shared by Langham. "While there are clear common goals amongst Brics members of increasing their geopolitical clout, reshaping and challenging existing global institutions and practices, and reducing their use of the US dollar, it would be a mistake to view members' geopolitical aims as homogenous," he says.

The Financial Times has reported that some members, particularly India and Brazil, have been unhappy with the anti-western rhetoric of China and Russia in meetings. Such cracks could create a chasm.

Langham nails this down further. "In India's case, there are concerns that the group is a vehicle for China to expand its influence. The expanded membership will add further complexities and likely limit the potential for any major initiatives to emanate from the group," he says.

Larose is more overt in his analysis, believing that China is the power behind the Brics' throne. "The expansion of the alliance was a China-led initiative aiming to challenge the geopolitical hegemony of the international community, that is the G7 and its sphere of influence across developed countries."

Negrete-Gruson highlights the lack of solidity among the Brics nations is a key factor in it lacking investor appeal. "There is limited economic cohesion among the new member countries, which further diminishes the enlarged group's potential to impact investment interests," she says. "Furthermore, the exclusionary nature of Brics hampers the economic progress of other smaller emerging market economies."

This culminates in a view that has Brics challenging the geopolitical order as somewhat naïve. "Concerns around the group challenging dollar hegemony for now seem overblown," Langham says. "Given the competing geopolitical aims of members and a lack of willingness amongst members to cede control over foreign exchange rates and/or monetary policy."

Looking at it from a perspective from within Brics, Fyodor Lukyanov, chairman of the Council on Foreign and Defense Policy, a Russian NGO, says the anti-western nature of Brics is overdone. "Current and future Brics members have one thing in common: they reject the right of the United States and the European Union to impose restrictions on other countries' foreign policy and economic activities," he says.

Emerging voice

And although the grand aims of Brics seem overstated, there is a perspective where Brics could gradually expand its influence, by speaking for emerging markets. "Brics, with its expanded membership, will seek to position itself as a voice for emerging economies and, as the G7's share of the global economy continues to decline, then there will be a push from the newly emerging economic powerhouses to have more influence on the global stage," Langham says.

Brics has become a misguided idea that size is the overriding determinant of emerging market performance.

Maria Negrete-Gruson, Artisan Partners

For investors, this has big implications, Langham says. "It means re-thinking geopolitics to accommodate for evolving spheres of influence. Debt relief resolutions may become more complicated going forward, potentially curtailing IMF lending," he says.

DeVito goes further, saying that increased co-operation and economic integration will make the bloc a more appealing investment proposition. "One only needs to look at the formation of the European Union, which started out as a loose steel and coal trading bloc in 1952," he says.

DeVito adds that opening up trade and allowing cross-border capital flows will make markets more efficient as confidence grows and risks are re-appraised. "It may also lead to enhanced infrastructure investment and technology transfer from the wealthier Brics countries into the weaker ones."

On this reading, DeVito adds: "The weaker countries may become more attractive as they obtain more guidance and investment from the stronger members, and this may well enhance the corporate investment opportunities available to external investors."

Unfulfilled promise

But going forward, Brics offers less, not more, attraction to investors, Negrete-Gruson says. "Brics is often marketed as a resilient sample of a historically volatile asset class, drawing investments away from smaller, equally deserving nations," she says. "Most crucially, Brics has not fulfilled its promise of resilience. Recent global economic events have exposed the vulnerability of these nations, rendering Brics a less appealing investment destination."

Therefore, she sees Brics as anathema from an investment perspective. "We don't believe in the idea of Brics as an investment bloc. These are individual countries with their own economic and political priorities. Each country wants to attract foreign investment, but that is probably where any universal similarity ends."

Negrete-Gruson therefore concludes: "It is simplistic and not constructive to lump these countries together for any particular purpose of analysis."

Larose agrees, highlighting that the newly expanded Brics holds little interest to investors. "The recent expansion of the Brics alliance is nowhere near to become an important factor in investment decisions."

Therefore, Brics, it could be said, is one serious example of how not to build an investment bloc.

DISCUSSION: SUSTAINABLE STRATEGIES

There are many roads to building a sustainable world. For some, the priority could be protecting the skies above us from the harmful gases that are altering our weather patterns. They could also be focused on preserving the natural habitats that purify our air and produce food and the ingredients needed to make medicines. Providing access to clean drinking water could also be one of the goals. *portfolio institutional* assembled a panel of insiders who own, manage and advise on such strategies to discover what sustainability means to institutional investors and how they are implementing it into their portfolios.

With sustainability meaning different things to different people, there are many ways to implement it into a portfolio.

Railpen, for instance, is a pension fund with £34bn of assets under management that integrates ESG and sustainability factors across all of its portfolios. "We think about the possible externalities, and how they could lead to negative outcomes for our members," said David Vyravipillai, a senior investment manager in Railpen's sustainable ownership team.

Whilst Railpen is trying to address the impact of climate change and other environmental issues, they also have a fiduciary duty to generate the best possible investment return for their members.

"We don't explicitly state that we are going to invest sustainably, but it can be implied by the fact that we are a long-term investor."

The Wiltshire Pension Fund also tries to embed this into all of their investments, although it does have a dedicated sustainable active equities strategy targeting environmental themes, an allocation to affordable housing, local renewable infrastructure exposure and now a Climate Opportunities fund.

For Freddie Woolfe, a global sustainable equities analyst at Jupiter Asset Management, the breadth of approaches to align members' savings with the delivery of a more sustainable world is one of its more interesting features.

He points to the UN's Sustainable Development Goals as an initiative that has created opportunity through setting key targets across a range of environmental and social imperatives to be achieved by 2030.

"In the discussions we have with clients, the interest is around delivery of real-world outcomes and transparency around what those real-world outcomes are," Woolfe said. "A key aspect for us is how the delivery of those outcomes underpins and supports the robust economic sustainability of the companies we are investing in."

Nico Aspinall, a sustainability advocate at Newton Investment Management, said the firm "thinks through the broad palette of different risks that come from the environmental, social and governance" elements in all of its products as part of its overall investment process.

"What is interesting is that the longer your time horizon, the more sustainable your portfolio has to be because we are aiming to incorporate things that might help address issues that are 15, 20 years out," Aspinall said.

"As an asset manager, our clients have a whole range of different objectives and time horizons. So it is valuable to have a sustainable label for some of our strategies so we can move from just targeting financial returns, to adding deliberate sustainable outcomes."

There are negative behaviours and practices that Newton keeps out of its sustainable portfolios, but sustainability is not just about risk, it's also a matter of trying to effect positive change. The firm looks for companies that understand its stakeholders and its environmental and social impacts to transition into future economies.

"So having processes in place to ensure you understand what a good chemical company or a good cement company looks like, in terms of how it is transitioning itself away from fossil fuels, is crucial, and could determine whether it is eligible for those sustainable strategies."

> **Even though there are challenges around ESG in emerging markets, it is important to invest sustainably.**
>
> Jennifer Devine, Wiltshire Pension Fund

Cadi Thomas, Isio's head of sustainable investment, said that every client she advises has different ambitions as to how much they want to push this, but the primary focus has been on climate change…perhaps overly so. "We are not saying climate change isn't important, but it's definitely dominated the discussions we have been having.

"I have often found that many people think low carbon equals good, which is, of course, not the case," she added. "This is changing slightly, moving towards more of a forward-looking focus and the identification of climate opportunities.

"We are also seeing increasing recognition of the interlinkages of climate change with social and nature issues."

Sustainable investing is a key priority at Russell Investments and has been incorporated into its investment thesis for many years, said Jihan Diolosa, its head of global ESG strategy.

"We are active owners of the assets we manage on our clients' behalf. Engagement with the underlying securities and voting are key pillars to our sustainable investing proposition.

"It is about having the right building blocks," she added. "Making sure that we have best in-class managers within our research universe to pick and build from is also a key requirement."

Nature's risks

After decades of investors being concerned about halting climate change another threat to the environment has emerged in recent years: biodiversity loss.

"It is a difficult place to know where to start as it is a massive issue and a lot of the information out there can be overwhelming," said Jennifer Devine, head of pensions at Wiltshire Pension Fund.

THE PANEL

Nico Aspinall
Sustainability advocate
Newton Investment Management

Jennifer Devine
Head of pensions
Wiltshire Pension Fund

Jihan Diolosa
Head of global ESG strategy
Russell Investments

Cadi Thomas
Head of sustainable investment
Isio

David Vyravipillai
Senior investment manager,
sustainable ownership
Railpen

Freddie Woolfe
Global sustainable equities analyst
Jupiter Asset Management

To help, the scheme has added a framework to its responsible investment policy. "We have been educating the committee who make the decisions on why this is important and how it might impact our portfolios.

"It's a little like climate in that you need to take a dual-pronged approach, looking at the risks and opportunities," she added.

From a risk perspective, the scheme focuses on the sectors that will be heavily impacted by nature loss, namely food and agriculture. "But you need to look at the opportunities as well, which is what we are trying to do," Devine said.

Opportunities to invest directly in natural capital are not easy to find for those looking to mitigate such risks, Vyravipillai admitted. "I'm yet to come across a fund in any asset class that doesn't sacrifice short-term alpha generation in order to address biodiversity in a positive manner."

He added that Railpen is still at the beginning of its biodiversity journey. "The way we look at natural capital is mapping our biodiversity risk exposure to better understand where to spend our time. That is the first point of call.

> **"We don't explicitly state that we are going to invest sustainably, but it can be implied by the fact that we are a long-term investor.**
> David Vyravipillai, Railpen

"We then engage with those assets to understand how they are mitigating such biodiversity risks in the near term," he added.

An easy way to protect against nature loss is to focus on deforestation or select a general environmental-based strategy. It's essential to recognise that nature-related risks and climate-related risks are interconnected. "Climate change can exacerbate the loss of natural capital by altering ecosystems and water scarcity. Organisations must therefore consider both sets of risks in their risk assessment and mitigation strategies," Diolosa said.

In the public space, she has seen a handful of nature-based solutions, but, in a sign of how young such strategies are, they have short-track records and Russell Investments has not formally ranked them, but instead are "keeping an eye on them".

The question is, can investors keep an eye on climate and biodiversity risks when looking at individual assets?

"At a high level, the two are inextricably linked," Woolfe said. "We cannot solve climate change without natural capital, and climate change impairs natural capital's ability to do that."

He then gave an example of how a Brazilian bank is tackling climate and nature loss in the Amazon through the loans it approves. "We consider that company to be a leader in addressing wrongful deforestation within the region by penalising those who are seen to be deforesting illegally, including through contractual mechanisms such as the cost of debt," Woolfe said.

"They are also looking to educate and incentivise people to use the Amazon's natural resources more sustainably so they can benefit from those resources without destroying them. Notably, there is a particular focus on helping small and micro businesses so there is an intersection with the delivery of real positive social impact from an economic inclusion aspect as well.

"What is interesting about that is you are looking at a company that has climate change and nature impacts as well as risks in its business and is looking to address them in a co-ordinated manner," he added. "I suspect that the leading companies in a range of sectors will increasingly look to incorporate both topics in a similar way."

Feed the world

Another threat to biodiversity is how we produce food. With the number of citizens on our planet projected to swell by 2 billion in the next 25 years, the pressure on the natural world looks set to increase.

"We have to try and short circuit the development curve," Aspinall said. "We need to put agricultural systems in place in the developing world that are not running off huge amounts of pollutants or tearing up virgin forests to grow their crops."

He added that this presents an opportunity for companies to scale up such technologies in the emerging world.

"The growing population means the pressure on the natural world is going to be huge," Aspinall said. "However, there is no reason why it should have to replicate the economy as it exists in the emerging markets today. We can aim to have more concentrated cities, which are supplied with water and energy that does not destroy the world around them, and are secure without triggering all sorts of chaos."

Wiltshire has been looking at forestry and agriculture through its Climate Opportunities fund. "I read some research that said there is enough land on our planet to feed everybody, but you have to stop eating meat. So it is also about changing behaviours," Devine said.

"Can you have a sustainable agriculture fund that invests in animal agriculture? I would argue not, but these things are out there, and you need to be honest in your assessment of if they are doing what you need them to do," she added.

> **"The growing population means the pressure on the natural world is going to be huge.**
>
> Nico Aspinall, Newton Investment Management

Thomas said that there is a lot of innovation in the natural capital space but food has always been something of a balancing act for investors. "You will find that a lot of the US forestry managers, for example, allow hunting on their land.

"There is the argument that this controls species, but I haven't seen a natural capital solution that purely focuses on food. Natural capital solutions typically contain commercial forestry, along with maybe some agriculture and peatland restoration. However, this is an area that is evolving quickly," she added.

Divestment or engagement?

Shifting the world from an extractive to a regenerative economy is a big change. Jobs will disappear as the skills we rely on to power our lives are replaced with new ones. This could decimate communities, and even countries, unless workers are reskilled. This is part of a strategy that is designed to "leave no one behind", known as a just transition, and is something Wiltshire asks its managers to consider when investing.

"It is important to us," Devine said. "It is part of what is going to make a transition sustainable. It is not going to happen if it is not fair to everybody."

There are two ways of creating a carbon-neutral economy. One is to invest in greener alternatives to the heavy emitters. The other is greening those heavy emitters. "Just having portfolio decarbonisation may be an anti-just transition narrative," Aspinall said. "There has to be a mixture of both in your portfolio, as its important to engage with the heavy emitters about their net-zero transition plans, rather than simply excluding them.

"Essentially, where their labour is focused today, and where it might be focused in the future, is all part of that just transition," Aspinall added. The engagement versus divestment point is interesting, Thomas said.

"You always have the challenge of can you genuinely quantify the impact you have had as a manager by engaging with that company. Where do you draw the line? When do you divest? Do you ever divest?

"One of the issues trustees are debating is where do they sit on that spectrum of exclusions versus engagement," Thomas added. "We need better stewardship reporting to understand if that is making a difference. That is the big challenge."

Russell Investments would typically favour engagement over divestment. For Diolosa, setting hard divestment rules is challenging because each company is different and so is every engagement. "We often debate if we should set up divestment rules. But it is hard to do given that how to approach or solve a particular issue raised will be company specific.

"So it is difficult to set a standard framework," she added. "As most engagements need to be done on a case-by-case basis.

> **We cannot solve climate change without natural capital, and climate change impairs natural capital's ability to do that.**
>
> Freddie Woolfe, Jupiter Asset Management

"Reporting and transparency of engagement outcomes are also important. We have developed a proprietary tool which tracks engagements over multiple channels to ensure that our clients understand the conversations we are having and the outcome of those conversations."

Regulation

Regulation is coming thick and fast in the sustainable investing space. Yet feelings regarding its effectiveness in helping to build sustainable portfolios are mixed.

"In terms of helping identify if a product is offering what it says on the tin, I would say regulation has not helped. You still need to conduct your due diligence," Diolosa said.

"You can't get away from that, but where it has been a benefit is helping investors pinpoint what could be a sustainable offering," she added. "The attention and focus on better disclosures are also welcomed."

The group then discussed if they feel that regulations are trying to make investors more effective. "What does making us more effective look like?" Woolfe asked. "Well, it is about keeping us on the straight and narrow and focusing on alignment with the delivery of real-world outcomes for people and planet rather than just managing for portfolio statistics."

"There is a lot of consultation going on, which is positive, and it feels like regulators and the investment community want to get this right.

"As the regulatory backdrop continues to evolve globally we have seen responses in the market shifting, but there is a heightened sense of authenticity which is hugely positive," Woolfe said. "And so if the regulations are in place to help clients understand what we do, why we do it and how we are aligning their savings with sustainable outcomes, that feels like things are definitely moving in the right direction."

Thomas pointed out that in the pensions space there is a lot of debate around if the Task Force on Climate-related Financial Disclosures (TCFD) adds value. "But trustees are having conversations now that they weren't having prior to TCFD," she added. "We are discussing topics such as climate tipping points and the resulting physical damage, which we wouldn't be having with all clients without this push from TCFD.

"But the issue is that you then end up with an 80-page TCFD report that aren't often read," Thomas said. "It is effective in terms of initiating conversations and everyone improving their knowledge, but not particularly in terms of communicating with members, which is half of what the regulation is meant to do."

Diolosa said there are many smaller asset owners who are still digesting TCFD and now are talking about the Taskforce on Nature-related Financial Disclosures [TNFD]. "There is a significant amount of strain on smaller schemes as there is a lot more that they need to educate themselves on and the world is moving on quite quickly.

"There are a lot of new frameworks coming through," she added. "TNFD has just been finalised, separately the DWP's taskforce on social factors has just released a draft guide for consultation. Against that backdrop the UK's FCA has just finalised the Sustainability Disclosure Requirements which will likely have implications for the categorisation of solutions that investors are currently invested in. It is a lot to digest."

Vyravipillai hopes to one day see a homogenisation of all these reporting standards. "That could be by the end of this decade. So in the grand scheme of reporting, that is still a positive step in the right direction."

He added that it is the same with TNFD. "We have already spoken about the overlap between biodiversity and climate and hopefully this leads to a combined TNFD and TCFD report in the future. That will ease the burden on asset owners, asset managers and corporates.

"We are heading towards a singularity of reporting standards with the formation of the ISSB," Vyravipillai added. "Regulation can be incredibly positive if all market players participate."

Transparency is crucial to helping members understand what is happening on their behalf. The Wiltshire Pension Fund produces mini magazines and one-page colourful factsheets to keep its members informed with what they are doing. "That is what you need, not 80-page reports," Devine said.

Aspinall focused on regulation being biased towards disclosure. "As an industry we must kill thousands of trees to print stuff nobody reads.

"TCFD is a framework to help schemes go through risk and strategic assessments. That has become a mandatory docu-

ment of the outputs of that process, but it doesn't necessarily guarantee a pension scheme has gone through a good process.

"In 2022, pension schemes had to go through it for the first time and it was such a rush," Aspinall added. "I'm sure that initially, they were more focused on simply producing the document and less focused on going through that risk and strategic assessment, but I'm sure they are having conversations that they have never had before as a result.

"So there is a bias in our disclosure regimes around the world to produce mountains of paper, which is ultimately meant to reflect on the process, but cannot give you that insight because the disclosures are not aligned to it."

Diolosa said the focus [on regulation] has shifted from disclosure to understanding. "I find with the large schemes I'm working with, the conversation has changed and is now focused on action."

> **Climate change can exacerbate the loss of natural capital by altering ecosystems and water scarcity.**
>
> Jihan Diolosa, Russell Investments

Vyravipillai added: "Ultimately, my job is to understand security fundamentals and not just provide ESG disclosures on the basis of our investment decision."

Thomas believes that the industry gets bogged down in the data. "The carbon footprint of an investment strategy is going to jump up and down because a market moves or a strategy changes.

"We get bogged down in justifying what the changes are, rather than just thinking about the bigger picture, which is: we have until 2030 to meet a decarbonisation target, what are we going to do strategically to get there?

"We don't look at the annual volatile numbers for returns, so I don't know why we do it on ESG metrics. That is interesting," she added.

"One of the key challenges is the metrics that tend to be reported on are inherently backward looking, but sustainable investing is fundamentally a forward-looking process," Woolfe said.

"We are looking to understand what will drive future cashflows and so some of these data points need to be company specific. Trying to aggregate and generalise is challenging and risks missing some of the more investment-relevant aspects."

Woolfe agrees that scepticism is required on how companies are going to achieve net zero – is their plan credible and will the next management team go back on those targets?

"Those are some of the key questions for assessing the credibility of a transition plan and its likelihood of delivery. A dataset on its own is not going to get you the answers that will help you invest most effectively as a sustainable investor, because it is about making an assessment of what you believe will happen in the future, which needs to include company-specifics and qualitative assessments," Woolfe said.

Emerging markets

The emerging world is becoming the new economic powerhouse fuelled by favourable demographics and an abundance of natural resources. Yet these nations are also home to high levels of inequality and pollution. So how can investors gain exposure to such growth while keeping their portfolios sustainable?

A lack of disclosure is one of the prime challenges in the emerging world, according to Aspinall. Lower listing requirements is one such issue. "If you want sustainability based on disclosure to define your portfolio, then you are probably going to have to exclude a lot of emerging-market companies."

Engagement is critical to improving the standard of corporate disclosures in the emerging world but can we in the West criticise their environmental and social practices?

"We can't sit here and tell them how to do things," Devine said. "Our own emissions can be low, but that is because we have outsourced our manufacturing. You can't have net zero for some, it has to be for everybody.

"So even though there are challenges around ESG in emerging markets, it is important to invest sustainably," she added. "That is something that we try to do. It would be easy to just sell high-emitting stocks to make our decarbonisation curve look better, but that is not the right approach."

Aspinall believes that a partnership approach to these problems could help the emerging world to emerge more sustainably. "You have to be in that opportunity space as a critical friend, but making sure that we are not removing capital on the basis of our western ideals," he said.

> **I have often found that many people think low carbon equals good, which is, of course, not the case.**
>
> Cadi Thomas, Isio

Engaging with countries is different to engaging with companies, but this should not be a barrier to investing. "As providers of equity and debt, if you are clear about what you are trying to achieve, and they are clear about what they are trying to achieve, then we can have a good conversation," Aspinall said.

However, he added that there are cultural differences between the West and some emerging nations to overcome, such as a high level of family ownership in some emerging-market companies. "That is a different conversation."

Woolfe says that regional nuances, for example corporate governance idiosyncrasies, demonstrate that a local market under-

standing is needed when investing there. “If you are looking to invest in companies that are leading the sustainable transition, you need to understand where they started from.

“Having blanket expectations across the world means you risk missing investment opportunities in companies that are demonstrating local leadership and delivering clear and tangible real-world outcomes.”

Diolosa added that when investing in emerging markets, you need to look at the trajectory that individual companies are on. “There are a lot of attractive opportunities in emerging markets.

“It depends on the country. But what we have found in the last five years is that companies are more receptive to having those conversations because they appreciate that the wider international audience want that further engagement,” she said.

Things to come

This discussion took place as we were closing in on the end of 2023, so what are the panellists expecting from sustainable investing in the years ahead?

For Devine, Railpen are ahead of their time in that they don’t have dedicated sustainable strategies; it is in every investment they make.

This is a mindset Wiltshire are moving towards. An example came when they were re-designing their website and had a page called ‘responsible investment’. “I thought: are the rest of our investments irresponsible?” Devine said. That page is now called ‘Investment’.

“It will become more like that,” she added. “It is going to become a lot more integrated. It will have to be.”

Vyravipillai agrees that in a few years’ time we won’t have ESG as a separate consideration to security fundamentals. “That is what makes me excited,” he said. “ESG investment professionals will be just investment professionals. The SFDR has formalised the importance of double materiality and the CSRD extends this.

“Securities should not only offer investors sustainable financial returns, but also an environmental and social return.”

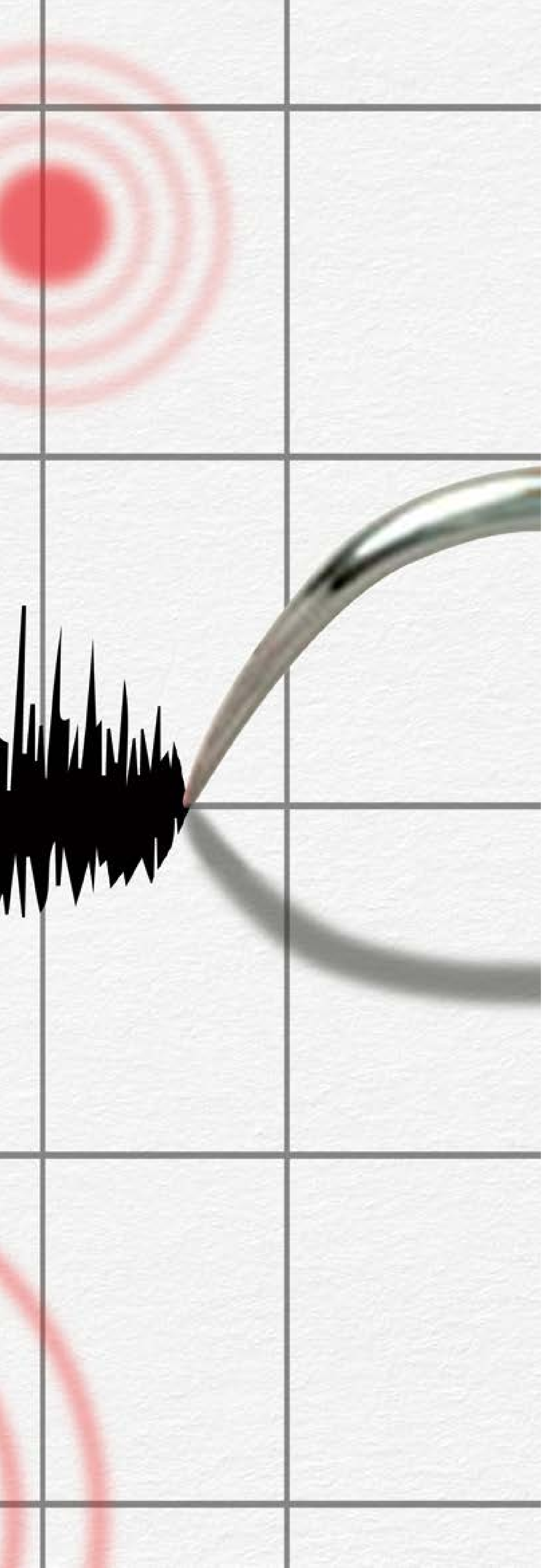
Aspinall chooses to focus on the “patchwork quilt” that is regulation, believing that it will get worse before it gets better. “I suspect the UK’s sustainability disclosure requirement is close. If you look at Europe, every country has a slightly different interpretation of SFDR requirements.”

He then points to the US, where the SEC can issue disclosure guidance, but each state can do the same, as California did in late 2023. And then there is Asia, where the standard of corporate disclosure could be higher.

“It will take time for us to work through that complexity,” Aspinall said. “That is probably going to be a big feature in 2024. But hopefully, further down the track, regulators will talk to each other on these matters and start harmonising their standards.”

Woolfe closes the discussion by concluding: “If corporate behaviour continues to develop in a way that means more companies operate more sustainably, our investment opportunity set should also expand. Societal and regulatory expectations and requirements are clearly evolving, even if some of the pathways are sometimes complex, to encourage companies along this route as well and increasingly penalise those that don’t meet those expectations. So we’re excited about the continued opportunities to support our clients’ financial outcomes by aligning their investments with those companies leading the transition to a more sustainable world.”

INFLATION: FROM A ROAR TO A WHIMPER?



How will an end to rising prices affect UK bonds and just how reliable are the measures of inflation underpinning this market? *Stephanie Hawthorne* surveyed an eclectic mix of experts for their views.

The spectre of 1970s-style inflation, a distant memory now but long thought vanquished, is still haunting the markets in 2024. In September 2023, rocked by a series of shocks – Brexit, Covid and Ukraine – Britain's consumer prices index (CPI) measured 10.1%, its highest rate for more than 40 years. Since then, inflation has tended to fall, but is still well above the Bank of England's 2% target. It expects steeper falls this year. Indeed, commodity prices have already fallen sharply from the spike seen in February 2022 when Russia invaded Ukraine.

Yet, after trending downwards, there was a surprise uptick in the latest UK inflation figures released on 17 January: CPI rose to 4% to December 2023 with food prices still eye-wateringly high at 8% and the cost of services sticky at 6.4%.

Further afield, eurozone inflation rose to 2.9% in December, up from 2.4% a month earlier while US inflation increased to 3.4%.

The rate of inflation matters to us all – from institutional investors to benefit claimants yet we see "through a glass darkly" with its path uncertain to 2024 and beyond. Indeed, *portfolio institutional* asked various experts for their predictions with inconclusive results.

One expert was Paul Rayner, head of alpha strategies at Royal London Asset Management, who seems to best sum up the uncertain outlook for 2024: "Labour markets remain tight, with European unemployment reaching its lowest level in 25 years and pay rises globally at worrying levels for central banks.

"Meanwhile, geopolitical risks remain elevated; the attacks in the Red Sea and Panama Canal blockages are already putting upward pressure on goods prices meaning inflation could remain sticky."

Rayner expects "global inflation to fall further in 2024, with US inflation falling to 2.7% and in the UK to 2.4% and remaining close to these levels in 2025. This, though, is still well above the target levels for the Federal Reserve and the Bank of England."

Remarkably, the disinflation during the past year has come without much visible damage to the labour market.

Altaf Kassam, EMEA head of investment strategy and research at State Street, says that outcome reflects the unusually strong starting point for labour markets across most developed economies.

"What was a hope a year ago has turned into reality: central banks, in their rate-hiking anti-inflation fight, have managed to restrict increased job openings without eradicating any jobs," Kassam adds. "That said, the ground becomes shakier from here. Job openings have indeed been declining and the 'margin of safety" is rapidly thinning".

"The time has now come for central banks to end the tightening cycle and allow prior hikes to filter through the economy," he adds.

The hard inflation fight

In the UK, the inflation fight may be harder than in most other countries as there is an additional layer of uncertainty due to labour shortages in some sectors.

Felipe Villarroel, partner of portfolio management at Twenty Four Asset Management, says: "The number of people who claim they cannot work due to long-term sickness continues to be high and this puts pressure on wages. Since the pandemic started this number has increased from 2.1 million people to 2.6 million."

Royal London's Rayner believes that bond markets have already priced in close to six interest rate cuts in most major markets by the end of 2024. "The improving outlook for base rates led to over a 100bp fall in yields in the last quarter of 2023. With inflation remaining above target, this pricing of interest rate cuts may be ambitious."

Gareth Colesmith, head of global rates and macro research at Insight Investment, concurs. "There is significant scope for disappointment if central banks fail to deliver, and rates are eased more slowly than markets expect despite a possible backdrop that is largely supportive to the bond market."

The end of 2023 had priced in around 150bp of cuts for the US and UK. Colesmith is far from optimistic. "Barring a significant drop off in economic activity, markets have made this disappointment almost inevitable. A combination of lower long-term rates, higher equity markets and tighter spreads have led to a significant easing in financial conditions. In effect, markets have already unwound the 100bp of rate hikes undertaken by the Fed in 2023, reducing the need for the Fed to do anything at all. The picture is similar in the UK."

Derry Pickford, asset allocation specialist at Aon, points to other factors that might drive bond yields lower. "The FOMC [Federal Open Market Committee] minutes, published on 3 January 2024, suggested that the FOMC is looking at curtailing quantitative tightening and that might spur the Bank of England – which has been even more aggressive than the Fed – to do something similar."

Many questions remain. The playoff between financial conditions and central bank policy is likely to characterise the investment landscape for the year ahead. This does not sit well with Colesmith. "If yields correct upwards as markets price in a more realistic path for rates, financial conditions will become more restrictive and open a window for central bank easing.

"If markets then rally, central banks are likely to, once again, become more reluctant to take rates lower. By taking advantage of these periodic corrections in yields, investors should be best placed to maximize their returns."

Lloyd Harris, head of fixed income at Premier Milton Investors, favours short-dated stock "given the lack of duration exposure in this part of the curve and this is where I would be positioned on the curve, at this point in time, for 2024."

By contrast, Iain Stealey, international CIO for fixed Income at JP Morgan Asset Management, suggests investors take a step back, as the long-term investment opportunity for bonds remains compelling. "Barring a re-acceleration in inflation, we have seen the peak in rates and central banks are likely done with tightening policy.

"Their next move will be easing which historically has been a positive environment for fixed income," he adds.

Secondly, he highlights from a valuation standpoint, core yields remain high relative to what has been available over the last couple of decades. "With inflation falling, this also makes them look attractive in real terms," Stealey says.

As a result, he believes it makes sense for investors to consider locking in these yields before the central banks get going cutting policy rates and bonds yields move even lower.

Dodgy foundations

More fundamentally, are institutional investors predictions built on sand? Just how reliable are the official measures of inflation on which so much hope or doom and gloom depend?

An Office for National Statistics (ONS) spokesperson told *portfolio institutional*: "Our headline measures of inflation are designed to reflect the average change in prices of all goods and services as consumed by all households. We collect over 180,000 prices across over 700 different items to use in the calculation of our headline measures. We are confident that these aggregate measures are an accurate reflection of overall inflation in the economy."

In the UK, the ONS reviews its "shopping baskets" of items used in compiling the various measures of consumer price inflation annually. In 2023, 26 items were added to the basket and 16 were removed out of a total of 743 items. The influence of the pandemic on the basket, has faded from shopping habits in 2023. The changes for 2023 point to the rise of new technology and an increasing awareness of the health and environment.

Additions included e-bikes, security or surveillance cameras, frozen berries and a new, detailed breakdown of rail fares based on transaction data, enabling analysis by ticket type. Removals included digital compact cameras, spirit-based drinks and non-chart CD albums bought in store.

"

Scrapping RPI and reverting to CPIH would revert to the eurozone's methodology, making it easier for investors to make relative comparisons on more international norms.

Neil Mehta, RBC BlueBay Asset Management

In addition, the ONS is developing radical new plans to increase the number of price points dramatically each month from 180,000 to hundreds of millions, using prices sent directly from supermarket checkouts.
Yet Yona Chesner, senior investment consultant and head of investments in Manchester at Cartwright, says: "All measures of price inflation are necessarily subjective because they make a subjective choice of what to include in their 'basket of goods' that they use to calculate overall price changes.
"Individual consumers will feel inflation differently depending on where most of their costs lie. Methodology issues such as substitution mean that inflation can be understated even for someone whose cost base is broadly reflected by the 'basket'."

RIP RPI

In the longer term, the Retail Price Index (RPI) is no longer a trusted measure of inflation and is being phased out. In 2020 the government announced that from February 2030 the RPI calculation will be changed to use the data and methods of Consumer Prices Index including owner occupiers' housing costs (CPIH). In effect, from that date, RPI will cease to exist as a separate index. As RPI is the inflation index used to set many pensioners benefits, as well as the index used to calculate payments that the government makes to holders of its own inflation-linked debt, from 2030 individuals as well as investors' wallets will be hit by the change.
The key difference between RPI and CPIH is that of methodology. In short, the way that CPIH is calculated means that it almost always comes out about 1% to 1.5% lower.
By way of an illustration, Cartwright points to historic annual RPI, CPI and CPIH from December 2023 to present. Over that period, RPI has on average been 1.4% higher than CPIH with CPI being 0.1% higher than CPIH (although there was a brief period in August 2020 where RPI fell to the same level as CPIH – 0.5%)
Despite this statistical tsunami of a reform coming in 2030, bond markets do not price in any significant change in RPI inflation around that date. Indeed, when the change was announced, market reaction was barely noticeable. Again, Cartwright sees this as a sign that gilt markets have been more driven by supply and demand forces – notably the demand from UK defined benefit pension funds – than the market forecasting a particular view on the timing of future inflation impacts.
Chesner sees opportunity here. "The astute bond investor may see this as an opportunity to benefit from the market's lack of sensitivity to this future expected event."
Indeed, RPI reform to CPIH in 2030 could have a large impact on assets linked to the former, such as index-linked gilts, DB pensions, student loans and mobile phone contracts.
Neil Mehta, portfolio manager at RBC BlueBay Asset Management, agrees with Cartwright's analysis. "There are positive and negatives. Given RPI has averaged +1% higher than CPIH since 2010, this will likely mean lower future returns for holders of Index linked gilts and pension schemes, hence the pushback.
"Scrapping RPI and reverting to CPIH would revert to the eurozone's methodology, making it easier for investors to make relative comparisons on more international norms."
But he warns: "The transition distorts the market forward inflation expectations-based measures, used by policymakers to anchor inflation expectations, such as '5yr breakeven' as it will incorporate RPI and CPIH in its calculation."

In conclusion

On the economic front, the path to that hoped for 'soft landing' may have a few detours. Tessa Mann, director of macro strategy at Willis Towers Watson, sees attractiveness in nominal and real developed market government bonds in absolute terms and as a strategy for hedging against downside events. "Government bonds offer great value as we enter 2024, with yields still remaining high relative to the last 10 years."
In general, fixed income is in a good spot globally with inflation falling and central banks starting to shift their tightening bias to a more neutral to easing bias. This will ultimately bode well for bonds and fixed income, but RBC BlueBay's Neil Mehta, says: "Be selective of jurisdiction and active when the asymmetry is favourable in a volatile environment for interest rates."
Perhaps nimble footwork rather than passive investment is the watchword for 2024?

THE FINAL COUNTDOWN

90%

The level of investors intending to maintain or increase their allocation to alternative assets, with 44% favouring private credit.

Source: Coller Capital

39%

Almost two out of five institutional investors 'strongly agree' that an ESG focus by developers encourages greater investment into property.

Source: Downing

2.3%

The growth forecast for the global economy in 2024, a slight fall on its 2.5% projection for last year.

Source: Pictet

16%

The expected five-year compound annual return from infrastructure, which beats the historical average by almost 400bps.

Source: Clearbridge Investments

$4.2trn

The estimated investment needed to achieve net zero by 2030.

Source: EFG Asset Management

5%

This year's expected global equity returns, down from 15% in 2023 due to lower corporate earnings.

Source: Pictet

£50bn-£65bn

The forecast size of 2024's defined benefit scheme de-risking market, which would make it a record year. This is based on insurers having larger deals in their pipelines.

Source: LCP

4.7%

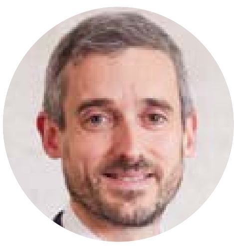
The expected return of emerging market stocks over the next seven years, which is below the 6.5% long-term historical US equity return benchmark.

Source: Aeon Investments

5.5%

The yield offered by local-currency EM sovereign debt by the end of 2024, down from 6.6% in November 2023, due to falling inflation and rate cuts.

Source: Pictet



Quote of the Month

"We cannot solve climate change without natural capital, and climate change impairs natural capital's ability to do that."

Freddie Woolfe, Jupiter Asset Management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