PORTFOLIO INSTITUTIONAL MARCH 2024

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IPOs:
IS THE DROUGHT OVER?

BIODIVERSITY
The climate change conundrum

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IPOs: IS THE DROUGHT OVER?

Private is the new public. Stock markets have traditionally been the place where companies raise the capital needed to fund the next leap in their growth plans or to take some cash off the table, but times have changed.

There is more private capital around today given the level of young sexy tech stocks working to repeat the success of Apple, Google and Facebook.

As a result companies are staying private for longer. Indeed, there was a 44% drop in IPOs globally in the first nine months of 2023. A build up in demand following the pandemic and higher interest rates may have been why the level of new listings was higher in 2022.

But London's stock market has shrunk by a quarter in the past decade, with only 24 companies floating last year, down from 45 in 2022 – a fall of 47%. This is a long-term issue with the number of publicly listed companies in the US dropping to around 4,000 from 5,500 in the first 20 years of this century, according to McKinsey.

Companies have been taken private, fuelled by cheap debt, and have not been replaced by fresh blood. Indeed, in the US between 2001 and 2010, 3,300 corporates de-listed and there were only 1,800 IPOs, according to McKinsey, although the level of exits and arrivals levelled out at around 2,100 in the decade that followed.

But could the tide be turning? Could corporate boardrooms view the public markets as an option once again to raise cash and secure new shareholders with deep pockets? Our cover story this month looks at the evidence that IPOs are on the verge of bouncing back. Read our findings from page 16.

We also look in more depth at why institutional investors have turned to private equity to provide the long-term growth their portfolios need from page 38.

This edition also examines where insurers will be investing their cash in what could be a difficult year for the markets. Are they prepared for the odd surprise along the way? Find out from page 20.

The importance of natural capital is placed under the microscope from page 32, particularly given its role in reducing the impact of climate change.

Finally, Now Pensions' new head of sustainability sits down for a chat about the challenges of the role and what he hopes to achieve (page 28), while Aoifinn Devitt, London CIV's new chief investment officer, discusses becoming a thought leader and proving the worth of pooling (page 12).

We hope you enjoy the issue.

Mark Dunne
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INVESTORS UNPHASED BY RECESSION

Market remains bullish on blue-chip index despite UK economic woes, finds *Andrew Holt*.

With the UK officially entering recession just two months into the year, will investors re-think their outlook for 2024?
Sanjay Raja, Deutsche Bank's chief UK economist, said that recession was expected in the second half of last year, but the fall in activity was deeper than expected.
"Q4 2023 GDP shrunk by 0.3%, quarter-on-quarter, dragged lower by weaker household and government spending," he said.
However, he added: "The bigger surprise was the fall in net trade with exports dropping by almost 3%, quarter on quarter."
This raises big questions for those responsible for monetary policy. "While the Bank of England's focus will likely remain on price data, the bigger drop in output and the politics of being in a technical recession will no doubt become uncomfortable especially with the bank rate at highly restrictive levels," Raja said.
Indeed, all eyes will be on the Bank of England now as speculation and anticipation grows that the Old Lady of Threadneedle Street could be forced to reduce rates sooner than expected to instigate some much-needed growth.

The shoe has dropped

But Sophie Lund-Yates, lead equity analyst at Hargreaves Lansdown, said that the FTSE100 "seems nonplussed" about the UK economy dipping into recession.
"One reason for the market's optimism is that this is a forward-looking measure, suggesting the outlook for company resilience hasn't really changed too much on this news," she said. "We've been waiting for the shoe to officially drop, and there will be some relief it's finally happened."
In fact, UK equities did see an interesting rise, as investors seemed to dismiss the news that the country has fallen into recession.
In the same way, the S&P500 hit record highs ahead of what is expected to be an abundant earnings season and a decline in the outlook for a global recession.

British bulls

In a similar 'don't panic' mode, Matthew Williams, managing director and head of institutional EMEA at Franklin Templeton, said a UK recession isn't something for investors to get too worried about.
"Notwithstanding the economic headwinds, there will always be interest in UK public and private markets," Williams said.
In fact, the situation may make UK assets more appealing to investors. "A slowing economy may well represent opportunities for asset owners who are shrewd, fundamental investors, whether they be domestically or internationally located," he said.
One overarching and enduring challenge for domestic investors "remains their local market allocations versus seeking diversification in other markets", Williams said.
That said, he noted that we are also witnessing a meaningful rotation of asset owners seeking to participate in the levelling up agenda, seeking exposure to real assets that incorporate an impact framework.

Global confidence

And the idea that investors should not be worried about any signs of a recession, technical or otherwise, is highlighted in the latest Bank of America investor survey.
It reveals that global investors are at their most bullish for two years, no longer expecting a recession, as confidence grows in the resilience of the global economy.
"Expectations for strong macro and no recession keep investors in the 'soft landing' camp at 65%, with 'hard landing' probability fading to just 11%," Bank of America said.
The fastest growing category for the economic and investment outlook is the 'no landing' scenario.
The survey showed 19% forecast no landing for the economy, dramatically up from 7% in the January survey – a big jump in one month.
Some 65% of respondents forecast a soft landing for the economy while 11% predict a hard scenario. In January, the numbers came out different: 79% predicted a soft or no-landing outlook, while 17% called for a hard landing.

The magnificent seven

But the survey did add an important caveat: that markets are pricing for a series of interest-rate cuts this year from the major central banks.
But it should be noted that among others, the Federal Reserve has pushed back against this narrative.
According to Bank of America, investors have gone in big on technology stocks, with allocation to the sector at its highest since August 2020 and with investors believing that 'long Magnificent 7' – a basket of the seven biggest US companies by market value that includes Apple and Microsoft – meaning this is the most crowded investment now.
Looking at what else investors have their eye on, Bank of America reveals that second on the list is short China stocks.
Chinese blue chips hit their lowest in five years during February, prompting the authorities in Beijing to roll out a series of measures to shore up the market and stem the outflows.

EMERGING MARKET ELECTIONS: WHAT INVESTORS NEED TO KNOW

The investor focus on emerging market elections reveals some interesting insights, says *Andrew Holt*.

In what is a big election year, the focus has, inevitably, been on the pending US and UK national elections.

Less covered is another set of elections, that of three national votes in emerging markets: Indonesia, South Africa and Mexico. Each present quirks and attractions to investors. So how should investors position themselves ahead of these elections?

In Indonesia, a first round victory was claimed by Prabowo Subianto and his running mate Gibran Rakabuming, who is soon to be ex-President Jokowi's son.

This election not moving to a second round in June reduces the political risk premium, and the influence of Jokowi via his son indicates policy continuity, said Dwyfor Evans, head of Asia-Pacific macro strategy at State Street Global Markets.

"Investors went into the election overweight the Indonesian rupiah, and while some of the shorter-term flow profiles allude to a modest lightening of positions in the run-up to the election, the actual outcome is as market friendly as can be expected," Evans added.

Disciplined macro

For Kim Catechis, investment strategist at the Franklin Templeton Institute, investors appreciate the country's disciplined macro-economic policies. "The steady increase in exports of processed metals means external deficits are unlikely to spiral out of control," he said. "Meanwhile, its improved infrastructure has helped limit logistic costs, thus helping control inflation."

In the election campaigns there was much talk of higher social welfare payments, which could potentially pressure the fiscal deficit, but the candidates also talked of tax reform to increase government revenues.

Regardless of the election, Catechis said: "Indonesia will be able to continue to balance relationships with China and the United States, while being well placed to build a key position in the new architecture of global supply chains, based around its critical mineral resources."

Looking at the impact of the inaugural presidential election of 2004 on the equity market, it returned +10% return within 44 trading days following the election date across the four presidential elections observed since 2004. Which bodes well for investors in the coming weeks and months. "In the periods leading up to elections, Indonesia's stock market predominantly exhibited positive returns, except for 2019, when the market showed flat to negative returns," Catechis said.

Hung parliament

But for Evans, the South African election is potentially the most interesting across emerging markets this year. "A political landscape dominated by the ANC for 30 years is at risk of fragmentation, as opinion polls indicate government support at around 40% to 45% and realistic prospects for the first ever hung parliament in South Africa," he said.

This, nevertheless, creates challenges, Evans said. South Africa's Constitution is centred on a hegemonic power structure, but regional or issue-specific coalitions is a positive to the extent that parties will need to work together in government, albeit against a backdrop of weak institutional structures, so this could easily break down. "For now, investors are constructive on the South African rand, but have reduced exposures to rand-denominated government bonds, which signals potential concern on South Africa's debt backdrop," Evans said.

And he added: "The uncertainty around the election outcome will impact political risk premium and investors may well want to hedge exposures as we move towards elections, which must be held by August 2024."

Mexican controversy

Mexican elections have become increasingly embroiled in controversy amid accusations that President Andrés Manuel López Obrador has proscribed constitutional reforms to pave the way for his preferred successor. Opinion polls continue to suggest another left-of-centre administration, but support has slipped over the past month and it remains to be seen whether this will continue given widespread, nationwide protests.

"Mexico is in the electoral crosshairs: it is also among the most vulnerable to a Trump re-election in the US, but investors continue to like Mexican assets for now given a number of supportive fundamental pillars," Evans said. "Exposure to Mexican peso assets will become potentially more volatile as we approach election season, not least is interest rate easing by central bank reduces Mexico's yield advantage."

For Blackrock, a change of government in Mexico this year "may usher in a more business-friendly environment" and could allow Mexico to capitalise on the nearshoring trend, the asset manager wrote in an investor outlook.

There are already benefits being seen in the country. "Mexico is enjoying the benefits of US companies relocating manufacturing away from China," added Andrew Dalrymple, investment manager at Aubrey Capital Management.

India could join the list of an emerging market facing elections and investor appeal. The country performed well in the fourth quarter last year "as earnings growth continued to surprise on the upside and foreign investors, who had been cautious with regards their Indian exposure in recent months, returned to the market," Dalrymple said.

PEOPLE MOVES

Railpen is looking for a new chief executive after **John Chilman** announced that he is to retire in 2025 after six years in the role.

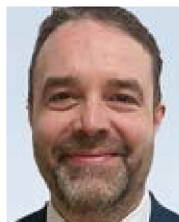
Chilman (*pictured*) joined the trustee board of the investment manager for the £34bn railway pension schemes in 2007, chairing the investment committee for four years until 2014. He then chaired the trustee board until he became chief executive in 2019.

Professional trustee provider **Independent Governance Group** welcomed several new faces to its team during December and January.

Mark Engelbretson joined as trustee director from Network Rail, where he spent seven years as director of pensions and was trustee director of Railpen for a time.

He is joined by **Susan Barber**, who has become an associate director. She returns to the firm after spending several years as a senior trust officer at Independent Trustee Services.

Trustee manager **Katherine Kitt** joins after holding a number of in-house pensions managerial roles, while new senior associate **Eleanor Rowe** also joins alongside associate Andrew Davy and assistant associates **James Lee** and **Sylvia Okolie**.



Finally, workplace pension scheme **TPT Retirement Solutions** has named **Marc Cox** as a consultant relationship manager.

Among his responsibilities, Cox (*pictured*) will identify and work with employee benefit consultants, particularly the fiduciary management oversight teams.

He has spent the last five years as head of HR for Mayar Capital.

CALENDAR

Topics for upcoming *portfolio institutional* events*

25 April
– Private markets conference

May
– Defined contribution roundtable

June
– Emerging markets roundtable

03 July
– ESG Club Conference

September
– AI roundtable

September
– DC and private markets

24 October
– *portfolio institutional* Awards

November
– Natural capital roundtable

*Subject to change

NOTICEBOARD

The Scottish Widows Master Trust is now receiving investment advice from **Isio**. The pensions consultancy will work with the master trust on asset allocation, manager selection and risk management.

Isio will also advise the trustees on the evolution of their investment proposition, which will include finding new sources of return, such as from private markets.

The investment portfolio of **Tesco's** defined benefit pension scheme will now be managed by **Schroders**.

The scheme, which is closed and fully funded, has been managed by Tesco Pension Investment, but following a strategic review of the long-term needs of the scheme the trustees decided to outsource the role.

Schroders will take full responsibility for the investment portfolio by the end of the year.

The Pension Protection Fund has selected the **Aviva Master Trust** as its defined contribution (DC) provider. The DC assets from any hybrid pension scheme that falls into insolvency will now be transferred to the master trust.

Legal & General Investment Management (LGIM) has lent a further £50m to **Jigsaw Homes**, which will help the affordable housing company build more than 4,000 properties by 2028.

LGIM has already invested £75m in the company, which builds or renovates affordable and social housing for rent or sale in the Northwest of England and the East Midlands.

LGIM has also invested £25m in hydroelectric and solar generation projects on various estates owned by the **National Trust**.

This is part of the charity's plan to be net zero by 2030.

Just has invested £33m in a healthcare operator, which supports children and adults with learning difficulties, trauma and complex needs. The funding, which has been described as "long term" and "inflation linked", is secured against the company's network of 33 properties.

The **Access** pool is stepping up its diversity of exposures by announcing a UK social and affordable housing mandate. The initial allocation is £125m with the potential to grow thereafter.

This comes after the £35bn pool started a search at the start of the year for timberland investment managers to manage a £300m global mandate.

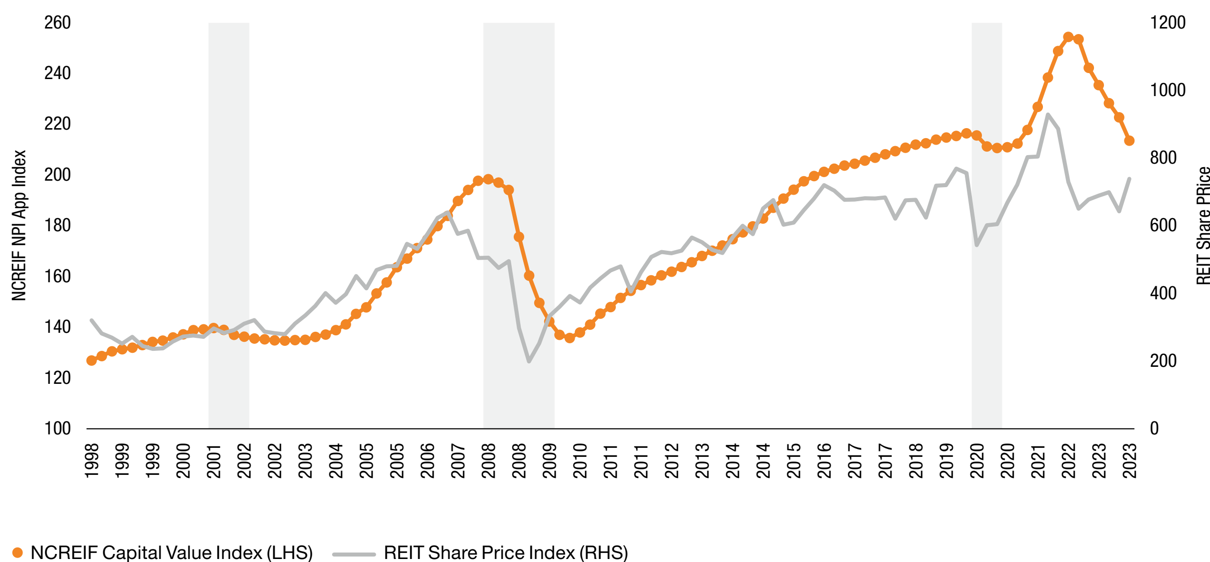
Just has also completed a £400m full buy-in of the pension scheme for workers of an un-named UK technology company. The deal has secured the benefits of the scheme's 4,000 members and removes the sponsor's longevity risk.

Finally, the insurer has also agreed a £9m full-scheme buy-in with the trustees of the **Birmingham Chamber of Commerce Pension Fund**.

The deal improves the benefit security for around 100 pensioners and 40 deferred members and takes the scheme a step closer to full buyout.

THE BIG PICTURE: IS COMMERCIAL PROPERTY SET FOR A TRANSFORMATIVE YEAR?

US Equity REIT Share Price And NCREIF (NPI) Capital Value Indices



Source: NCREIF, NAREIT, Principal Real Estate Investors. Data as of December 31, 2023

Despite facing challenges on many fronts, there are signs that commercial property could experience some form of bounce back, finds *Andrew Holt*.

After a turbulent 2023, there is a concern that commercial real estate (CRE) will face additional challenges in the year ahead.
While offices may remain vulnerable, other sectors are well-funded and will be supported by a constructive economic backdrop, setting the stage for a transformative year for the asset class.
Last year was CRE's most challenging since 2009, impacted somewhat by the Fed's policy tightening and the regional banking crisis.
Consequently, a significant withdrawal of debt led to a sharp drop in property sales.
The CRE market now faces heightened refinancing risks, with $1.2tn (£947bn) of debt maturing by 2025 amidst tough lending conditions and higher interest rates.
While the maturity wall is undoubtedly significant, the overall refinancing risk to the CRE market should be relatively well contained for three reasons, said Seema Shah, chief global strategist at Principal Asset Management.
One, given the potential contagion impact in CRE, policymakers are keen to avoid additional stress on the financial system, and would be quick to head off any periods of illiquidity and distress in CRE and the banks.
Two, a resilient US economy is supporting tenant demand across the commercial property sector.
Three, although nearly 20% of the CRE debt scheduled to mature in 2024 is in the challenged office sector, others, such as apartments – more than 30% of the outstanding debt – enjoy stronger fundaments and more secure liquidity.
Shah also noted that given the sector-specific nature of CRE, and the extremely attractive valuations compared to prior years, the main determinant of the sector's performance this year will likely be the durability of the economic expansion, rather than refinancing risk.
What this could mean is if the Fed can pivot to an easing cycle against the backdrop of ample liquidity and positive economic growth, 2024 could provide a transition point for the CRE market.

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

AMNT BACKS MOVES TO MAKE VOTE REPORTING MANDATORY

AMNT has welcomed the amendment to the *Digital Markets, Competition and Consumers Bill* by Baroness Wheatcroft, which calls for mandatory, transparent vote reporting from fund managers.

AMNT has long campaigned on this issue. After all, pension schemes and trustees pay fund managers to do a job. And they are asking for a basic but important right – to direct votes as shareholders on issues of importance to the members of their scheme. It doesn't seem much to ask for, but it has been a struggle to get the majority of fund managers to listen. However, this could be about to change because of legislation currently passing through the House of Lords. Let me explain.

Baroness Wheatcroft's amendment to the Bill, which is backed by voting and stewardship fintech firm Tumelo, would give the FCA a legally binding duty to make rules requiring investment managers and insurers to give all pension scheme providers standardised information on all votes relating to their investments within 30 days of receiving the request.

Existing FCA rules do not achieve this. Legally required reporting is annual and does not cover any prescribed reporting period, is not standardised and is at firm level, not fund level – so a pension fund cannot distinguish between a few hundred votes cast on their behalf and many thousands of votes on other companies in which they are not invested.

Finally, it is only "comply or explain" allowing managers and insurers to opt out of the whole process. Whilst the FCA consulted on standardised reporting in the summer of 2023, they only proposed a voluntary approach – and the FCA have yet to respond to their consultation. We do not think this is far enough – and neither does Baroness Wheatcroft or Tumelo.

In essence, this amendment would be helpful to pension schemes as most employ several fund managers and the response to requests for information varies greatly from manager to manager and by time period covered.

Baroness Wheatcroft, who is a non-party aligned peer, hit the nail on the head when she said: "Government has regularly said that stewardship – including voting – is essential to good corporate governance and good investor outcomes, as well as wider policy goals such as net zero.

"To put this principle into action, we need transparent, consistent, comprehensive fund-level voting information for pension providers, so they can hold their managers to account. My amendment will enable trustees and others to make better decisions on behalf of consumers and make the UK a better place to invest."

That is totally in line with our thinking – and the very thing that many fund managers have not been doing for their pension fund clients who invest in pooled funds.

The amendment was debated in the House of Lords in early February. As reported in Hansard, Lord Offord, responding for the government, suggested "that we speak to the treasury and write to the noble Baroness on a number of her questions, in particular to draw on the comparisons with the US, with which we are so close on so many things, to understand what its experience is and where we are in comparison".

The Conservative Lord Lucas added: "Capitalism will not survive unless we institute a structure that allows the people providing the money to have a real and active interest in what is going on with the money they have invested."

Whatever happens next, the AMNT will not let this issue disappear. We will be following progress avidly and will continue to raise our voice on this subject. We believe it is only right and fair that pension scheme members have their wishes respected when it comes to voting on vital ESG issues including diversity and climate change. The excuse that it is "too difficult" for fund managers to undertake this process for those many millions whose investments are handled through pooled funds is no longer viable.

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PRIVATE MARKETS COULD SPELL BIGGER RETURNS FOR PENSION FUNDS

2023 was a reformative year for pensions, with Jeremy Hunt unveiling plans to enhance productivity and increase returns on pension savings.

The political push to encourage pension funds to invest more in private assets is set to continue throughout 2024. In his most recent Autumn Statement, the chancellor announced a sweeping package of pensions reform to enable pension funds to diversify their portfolios, invest in high growth companies and drive a more consolidated pensions market – which could spell juicier returns for investors.

Aviva, Scottish Widows, Legal & General, Aegon, Phoenix, Nest, Smart Pension, M&G and Mercer pledged to allocate a minimum of 5% of default fund assets to investments in unlisted equities by 2030. With pension funds representing two-thirds of the UK's defined contribution (DC) market, this represents an important commitment to provide savers with more exposure to private markets and forms a key component of the next phase of the Manson House reforms.

These reforms have the potential to help pension funds diversify their portfolios and achieve higher longer-term returns – bringing benefits to pension savers and the British economy. However, the devil is in the detail: any push into private assets comes with a fair share of challenges, and the operational aspects of this push must be considered.

Concerns about UK pension funds' lack of domestic exposure have been rumbling in the background for some time. According to the government's Pension Charges Survey, about two-thirds of the UK's DC pension schemes have zero exposure to illiquids in their default funds, while the remaining third have between 1.5% and 7% of exposure. The main barriers to investing in private markets relate to the high cost of doing so.

The need to diversify portfolios, achieve a premium on investment returns, and manage risk has been the driver behind the chancellor's push to get pension funds to invest more in private assets. Yet in 2000, 39% of London Stock Exchange shares were owned by UK pension funds and insurers. But by 2020, the figure had dwindled to 4%. The Capital Markets Industry Taskforce is lobbying for consolidation across the pensions space, saying in a letter to the Chancellor last year that the DC market is "highly fragmented by international standards" with close to 27,000 schemes, 25,700 of which have fewer than 12 members.

This all points to more pension fund capital flowing into UK private markets in the coming years – potentially from a consolidated number of large players. If done right, pension funds could diversify their portfolios, achieve a premium on investment returns, and manage risk.

However, as well as new investment risk considerations, pensions funds must consider the fact that this asset class may pose operational and back-office challenges. Most pension funds are accustomed to the standardised reporting of public markets. In contrast, private market investments are more difficult to benchmark, reporting is less frequent and the detail of reports varies greatly. Although the back-office functions may not be deemed critical on the surface, they play a crucial role in determining the success of investments. It is through these functions that we gain insights into whether investments are performing well or not.

A high degree of specialism is also required. Private equity fund managers will often spend years working with a company and will have a deep understanding of how the respective markets behave.

Yet access to comparable data is a challenge, and unless pension fund managers and trustees can view and analyse that data, it will be like driving a car backwards.

As pension funds action the shift to private markets, access to timely and tailored portfolio information is critical.

New reforms in 2024 and beyond will open up huge growth potential for the pensions landscape and potentially boost British industry in the process. By working with expert providers, evaluating the performance of investments through an effective back office, and managing the complexities of private market data, pension funds can maximise the benefits – and overcome the obstacles.

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INTERVIEW – AOIFINN DEVITT

"Every pool has done something slightly different. Every pool has its own DNA."

The new chief investment officer (CIO) of London CIV tells *Andrew Holt* about her mission, becoming a thought leader, working with 32 partner funds and being inward and outward looking at the same time.

How have your first few weeks in the role been?

There have been a lot of voices to listen to through my "Coffee with the CIO" initiative. This is an engagement that I host every Wednesday. It had a good start with 30-plus people on the first call.

The point is to reach out to our clients to find out what they would like to hear from us, or if they want to ask me anything.

What have been the big challenges you have had to deal with?

There are always challenges when you come into a role, especially where there has been a CIO gap. There is a need to hit the ground running. That has been possible because people have been willing to come up with lists of what needs to be done.

The main challenge is to be inward and outward looking at the same time. And there are so many imperatives when it comes to fund launches and client engagement.

What are your priorities as CIO?

Delivering a top performance for the funds already in place, providing value for money and for partner funds to make savings that are the promise of pooling.

Have you identified areas that you would like to change?

I want to elevate London CIV into one of the most notable institutional investors in the UK. I want us to be a thought leader. To be at the forefront of product evolution and to lead the Local Government Pension Scheme (LGPS).

I have been working for the LGPS for about 15 years in various forms. As a body for open defined benefit pension schemes, it is unparalleled in the UK for its force.

What attracted you to the role?

London is one of the most exciting and

dynamic financial centres in the world. Having a role based here is extremely attractive. We get foot traffic from every asset manager you can imagine and access the best investment ideas.

Then it comes to my own, personal public service calling. Something I have carried my whole life is a desire to educate and ensure that knowledge is power, and the more knowledge that is disseminated the less likely investment mistakes are going to happen.

My maturing time was [the global financial crisis in] 2008 and [Bernie] Madoff. I had just started working in hedge funds and to see the belief in strategies where so much due diligence had been conducted just disappear overnight due to them being a sham was a real education on the headline risk that goes with alternatives.

You have an impressive CV, having worked for some leading asset managers. How different will being the CIO of an asset owner be?

As an asset owner you are looking at solutions or constructing your own, as we are, and that is clearly a difference.

But having sat on the other side, as I did at Federated Hermes, and having had my own fund of funds back in 2010, I have seen asset managers evolve into a consultative partnership model. That is ultimately where we will be.

It is not going to be transaction based, there will be a desire to add value through consulting and asset allocation with the fee-advisory bit attached to the fund provision.

I saw that with my fund management hat on, and now as an asset allocator I can see what we should expect from our partners. They can help us on this journey in thinking about net zero and with risk management. They can help us in a number of ways to take a better holistic approach.

Upon taking up the role you said you wanted to "develop a suite of investment products that reflects the evolving imperatives around net zero, cashflow generation and portfolio resilience". What will this mean in reality?

On net zero, different clients have different degrees of how it dominates their allocation. For some it is much more focused, but we will cater for their net-zero goals through integrating ESG metrics across our entire portfolio.

We have a dedicated product for nature-based investments through our Natural Capital fund. In building out natural capital investments, the plan is to further align London CIV's offering with the investment goals of our partner funds.

I also look at where the wants and needs are and the areas where we can make a difference. And cashflow generation is important. This is because many of our partner funds are becoming structurally negative in terms of cashflow. They are aging, or may not have many active participants, so their cashflow profile will change, meaning that there is going to be a need to orientate the asset allocation around cash generation.

I have a lot of experience with that because I worked on a severely underfunded pension plan in Chicago, which needed to generate cash. That may be the future of the LGPS, hopefully not on that level of funding, but certainly negative cashflow, so we need to cater for that.

And resilience gets to every investor's want and need: which is an all-weather portfolio that is diversified, protected against sterling weakness and a weak UK economy. It is all about global diversification, as well as building in multi-asset diversification.

So that resilience has been catered to with inflation hedging, like infrastructure and real estate investments.

Do you have any new investment plans for your partner funds?

We have some investments that we think

We are greater than the sum of our parts. If we focus on that, then the results will be obvious.

should get more airtime. One of those is our UK Housing fund, which is actually an affordable housing fund so is in the impact arena. There is a real need for housing across the UK and this is focused on the different segments of that, of making an impact on housing for vulnerable adults.

The other thing to state is that we have a Renewable Infrastructure fund, which has seen a lot of good traction. We also have a mainstream infrastructure fund. The demand for that represents the evolving need.

***portfolio institutional* reported last year that the Royal Borough of Kensington and Chelsea's pension fund wanted to leave London CIV, which didn't come to fruition. How is that relationship today?**

Without commenting specifically on the relationship, which I don't have as I haven't met them yet, the different levels of conviction around pooling, not just in London CIV, is that we must prove our worth.

That is something we are committed to doing. We are focused on the promise of pooling, which is: cost savings, benefits of scale and efficiency.

We are greater than the sum of our parts. If we focus on that, then the results will be obvious.

How big a challenge will having 32 partner funds be?

The question is finding the thread of commonality and then finding the areas of thematic differences and seeing whether we can cater to them and make ourselves flexible.

What do you make of the government's aim for funds to consolidate all their assets into their respective pools by March 2025 and other initiatives like nudging investment towards private assets?

They look like they may force the issue, or at least create a bit more urgency with those that have not done it yet. The pools have seasoned well, they have developed their products and have decent track records. So there is a proof statement around the savings that can be made.

There are enough off-the-shelf offerings to cater for the whole audience, so there should be no issue with the timeframe.

Some initiatives, like putting 10% in privates, are blunt. The devil is in the detail. Not every private asset is a good investment because of the illiquidity and the high fees.

Do you see any problems with any of this?

If we continue to deliver on our promise, hopefully it will become self-evident to be fully part of a pool.

On the investments, if it creates a rushing mentality, that could be a problem. Privates are an area that should not be rushed. They are an area you need to be educated on as they are highly complex. There needs to be an eyes-wide-open approach about the liquidity needs, the time horizons and the complex nature of these investments.

Privates are an area that should not be rushed.

When it comes to Levelling Up, clearly that is when impact and returns can be married together. The key is not sacrificing one for the other.

What do you make of the government looking to consolidate the pooling system with a move to a smaller number of pools?

That is a longer-dated goal. That may be the natural evolution of things as pools continue to mature. We see this with any business: a natural sifting out, a natural restructuring and realigning. We are focused on delivering our mission right now.

London CIV works through an authorised contractual scheme structure. How does that work?

Basically, we are FCA-regulated and subject to the same standards as any asset manager would be, which is an important distinction as it gives a good credibility layer of official authenticity to a pool.

As far as the structure is concerned, it involves the regulatory regime, which is strict and can be onerous at times, but that is what every fund manager goes through.

How has London CIV undertaken its role within the pooling system since its inception?

There has been an evolution of our journey and that has been quite dramatic in recent years. We started well ahead of some of the other pools and with our 32 clients, which can sometimes slow the process because it can be harder to build consensus among all the shareholders.

But we have made significant strides on the journey. We are taking a seat at the table as a credible voice alongside the other pools at this point. As I say, we want to be a thought leader and lead the pack. Every pool has done something slightly different. Every pool has its own DNA.

What then is London CIV's DNA?

With our 32 pools and the fact we started early, we were in existence before there was any mandate, so we make sense naturally.

Also being in London, being in the centre of financial innovation, has enabled us to get on the front foot. London is a petri dish of some of the challenges the LGPS faces across the country: housing shortages, budget shortfalls and volatility in a change of the political wind.

In a way, with 32 clients, we are going to see it all. So that enables us to be quite nimble.

Has the geopolitical situation and high inflation had any bearing on how you undertake your work and any investments you are planning?

We are not investing in a vacuum. So even though we are long-term investors we need to be aware of the context in which we invest. But we must answer the 'so what' question. It is nice to talk about where the Fed is going next and what the Bank of England is going to do, but what does it mean for portfolios.

As far as we are today, we are looking more at inflation. Not quite in the rear-view mirror but decelerating and falling. Do interest rates follow? If so, what does that mean for real estate and infrastructure – things that are interest-rate dependent – as well as fixed income.

On the equity side, we have all been scratching our heads at the dominance of the US market and the tech stocks there, and the languishing of London's stock market, which is frustrating for UK investors. Thankfully, all our clients have global exposure. We are looking at what is the endgame here. Do markets begin to get a little less concentrated and what does that mean for portfolios?

How do you see the outlook for the rest of 2024?

The US is a good barometer for the rest of the world. With the strength of its economy, the strong consumer and job picture and the fact that central banks around the world have got quite an arsenal now to cut rates next time. So they have bullets back in the chamber to use later to stimulate, should the need be there.

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

What is in it for me? We talk about showing off our knowledge but when it comes back to the audience, what do they want to hear and what makes them walk away. So it is that translation part. And I didn't always appreciate that. It is important to leave the audience with some understanding and learning to take away.

AOIFINN DEVITT'S CV

January 2024 – present
Chief investment officer
London CIV

January 2024 – present
Chair, investment committee
Moneta

June 2021 – January 2024
Chief investment officer
Moneta

January 2019 – June 2021
Head of investment – Ireland
Federated Hermes International

April 2016 – January 2019
Chief investment officer
Policemen's Annuity and Benefit Fund of Chicago

August 2011 – May 2012
Head of client strategies – Ignis Advisors
Ignis Asset Management

2006 – March 2016
Founder
Clontarf Capital

August 2002 – August 2006
Specialist consultant
Cambridge Consultants

July 2000 – March 2002
Associate
Goldman Sachs

October 1995 – June 1999
Associate – New York/Hong Kong
Debevoise & Plimpton

IPOs:
IS THE DROUGHT OVER?

The IPO market has been pronounced as being close to death, yet indications suggest it is ready to bounce back big time, with big ramifications for investors, finds *Andrew Holt*.

The parlous state of initial public offerings (IPOs) has been a source of much debate within the investment world for some time. Some have even proclaimed the death of the IPO. That seems somewhat extreme but does touch on the crisis within that market.

The current path of IPOs seems significantly more positive. Despite a challenging and unpredictable global economy and geopolitical outlook, the prospects for IPOs are predicted to vastly improve in 2024. "We expect to see companies and investors put their toes in the water this year and start to test the temperature again after a good while away," says Stuart Newman, capital markets partner at PwC UK.

A big factor is simply down to the fact that investor sentiment turned more positive towards the end of 2023, Newman says. This was largely due to gradually improving macro-economic conditions, particularly falling inflation and a stabilisation of interest rates with major central banks signalling the end of their respective hawkish monetary policies.

"This more optimistic macro outlook, reduced volatility and stronger than expected equity indices performance in 2023, together with a growing demand for exits all point to a potential re-opening of Western IPO markets in 2024," Newman adds.

Depressed markets

There is no doubt that IPOs are coming from a place of exceptional weakness. Any such bounce will come on the back of a depressed market for new entrants in 2023. The London stock market saw just 23 companies list last year, a 49% decline on the 45 recorded in 2022, and represents the quietest year on record since 2010, when EY first started collating its data.

Breaking this down, the 23 companies that floated for the first time collectively raised £953.7m, down 40% from the £1.6bn new entrants shared a year earlier. The largest market debut in 2023 was CAB Payments, which raised £291.5m in July.

Interestingly, in the final quarter of 2023 there were no IPOs on the main market or Alternative Investment Market as the London stock market continued to be affected by the much cited headwinds of rising inflation, interest rate rises and geopolitical tensions.

Putting this in context, Scott McCubbin, EY's IPO leader in the UK and Ireland, says: "The challenging macro-economic conditions which drove a slowdown in overall M&A market activity in 2023 had a knock-on effect on IPOs, with a relative pause in activity towards the end of the year."

And he notes that the stability of equity markets hinges on consistent conditions, which may limit a complete IPO bounce. "So whilst falling inflation and interest-rate reductions may ease in the first half of 2024, the upcoming UK and US elections in the latter half might delay significant IPO activities until 2025."

That said, McCubbin points to reasons underpinning a potential IPO bounce. "The fundamentals of London as an attractive global listing destination remain strong, and pent-up demand for IPOs suggests we are likely to see an upturn in the market in the second half of the year as economic challenges continue to ease," he says.

McCubbin also lists the FCA's revisions to simplify the UK listing regime – particularly the increased emphasis on disclosure to empower investor decision-making – should also provide a boost and have been broadly welcomed by the market.

A global view

Looking at the IPO numbers on a global level, the stats make fascinating reading. Overall, volume fell 8% in 2023, with proceeds down by 33% compared with 2022. In total, 1,298 IPOs raised $123.2bn (£97.6bn) between them.

As to be expected, technology IPOs continued to have the highest proceeds, raising $32.2bn (£25.5bn). However, the sector saw declines driven by subdued investor reception to high-profile tech IPOs in the US and generative artificial intelligence (GenAI) startups still being at the venture capital stage.
The industrials sector had the most deals in 2023 at 265, while the consumer sector was the only sector to increase by IPO volume and proceeds, year-on-year.
Across the water, the picture was an encouraging one. The number of IPOs in the Americas were up 15% to 153 deals compared with 2022, with several high-profile deals helping to drive three-fold proceed increases to $22.7bn (£17.9bn).
While in the Asia-Pacific region, 732 companies raised $69.4bn (£54.9bn), an annual fall of 18% in volume and 44% in value, with mainland China and Hong Kong continuing to decline in volume and value.
Putting Europe with the IPO markets in the Middle East, India and Africa reveals a 7% rise in volume contrasted by a 39% decrease in proceeds with 413 deals raising $31.1bn (£24.6bn) in total. Interestingly, when identifying new IPO 'bright spots' the Middle East, Indonesia and India are cited enthusiastically by PwC.

The only way is up

Although looking at these numbers overall, one could suggest that an IPO bounce comes not from strength, but from the fact that it could not get any worse. In other words: the only way must be up.
But the positive outlook is built on something more and part of an on-going growth, says Dan Dees, co-head of Goldman Sachs' global banking and markets business. "IPO activity, which has started to pick up in recent months, should accelerate in the back half of 2024, especially if the Fed starts cutting rates," Dees says.
He makes the point that it is not unusual for the IPO market to open and close. When financial markets are strong, public offerings tend to be robust, and vice versa. "The environment for capital raising will be robust – because it has to be – in the years ahead," Dees says. In essence, markets need capital. And IPOs feed that need.
Furthermore, a pipeline of IPOs could be coming based on data revealed by EY in October, which highlighted in a CEO outlook survey that 40% of private companies have transactions in sight over the next 12 months and are exploring an IPO as an option. This alone could easily boost IPO activity in 2024.
Plus, what is inevitably going to be a re-occurring theme in the new world of IPOs, is the issue of innovation. "We are in the age of innovation, of accelerating innovation. All that innovation needs to be funded," Dees says.

We expect to see companies and investors put their toes in the water this year and start to test the temperature again after a good while away.

Stuart Newman, PwC UK

Renaissance

Sophie Lund-Yates, lead equity analyst at Hargreaves Lansdown, shares the growing optimism that the IPO market is set to come roaring back to life.
"In 2024, the IPO market is potentially poised for a renaissance, opening up opportunity for investors," she says.
Several factors are to thank for this. "Firstly, technological innovation is driving unprecedented demand for fresh capital to fuel growth," Lund-Yates says.
She also highlights the innovative nature of the market, which needs capital to fuel such developments. "From breakthroughs in AI to advancements in renewable energy, companies at the forefront of these rapidly changing industries are eager to tap into public markets," she says.
At the same time, Lund-Yates highlights how regulatory reforms and investor-friendly policies are bolstering confidence in the IPO landscape.
"Governments worldwide are increasingly streamlining processes, reducing barriers, and enhancing transparency, creating an environment for companies to debut on stock exchanges," she says. "This regulatory tailwind not only fosters trust among investors but also enhances the attractiveness of going public."

A fundamental story

Another reason for optimism is that the global economic landscape seems to be returning to a slightly more even keel. Inflation is, albeit gradually and with some bumps along the way, moving in the right direction, which has helped settle market nerves.

Within this, George Chan, EY's global IPO leader, has identified some investor trends. "Faced with tighter liquidity and a higher cost of capital, investors are turning to companies with strong fundamentals and a path to profitability," he says.

In response, IPO prospects need to demonstrate their financial health and potential for value creation. "As valuation gaps narrow, investors are reviewing the post-listing performance of the new cohort of IPOs, which, if positive, could renew market confidence," Chan adds.

For Chan, the picture associated with the 'fundamentals' view is vitally important. "Investors will continue to care more about the fundamentals, such as a strong balance sheet, healthy cashflows and resilience amid weak economic conditions rather than how fast the company can grow and how high the valuation could reach," he says.

IPO candidates will, Chan says, need to be agile with innovative business models, be resilient when facing supply-chain constraints and macro-economic challenges, have strong working capital and be able to adapt to new ways of doing business by embracing technology and AI applications.

High growth, high risks

Reinforcing this analysis, Debbie O'Hanlon, EY's private leader for the UK and Ireland, says market conditions remain challenging, but appetite for a public listing is high and smaller deals are having improved after-market performance. "With many governments now taking measures to boost IPO activity – particularly in high-growth economies – it's essential that IPO candidates focus on building fundamentals and managing price expectations to be 'IPO ready'," she says.

IPO activity, which has started to pick up in recent months, should accelerate in the back half of 2024, especially if the Fed starts cutting rates.

Dan Dees, Goldman Sachs

Investors though do need to proceed with a semblance of caution. There are issues that while getting in early on a stock that could go on to shoot for the moon could well mean strong returns, but younger companies also carry more risk. Many have yet to prove recurring profit generation or cashflow, making them less able to deal with the ups and downs of the market.

"Investing in a company listing shares for the first time can offer opportunity – getting in before valuations have had a chance to grow can be better than opting in when they peak. At the same time, investing in an IPO can be risky," Lund-Yates says.

Keeping an eye on the longer-term outlook of a company is important, she adds. "Investing is for the long term, that's at least five years – you need to have confidence in the long-term prospects of any company you're investing in," she says.

Indeed, investing in IPOs, share offers and individual companies isn't right for everyone. "It's a higher-risk way to invest," Lund-Yates says. "When a company first lists on the stock market, its share price can rise and fall quickly. If the company fails, you could lose your whole investment."

Therefore investors need to do their research. "You should make sure you understand the companies you're investing in and their specific risks. You should also make sure any shares you own are part of a diversified portfolio," Lund Yates says.

Testing valuations

So what sectors should investors be looking at? "Technology remained the most active sector for IPOs globally and, whilst we expect this trend to continue, IPO valuations will be tested as recent aftermarket performance remains mixed," Newman says.

There are also other sectors that tick the correct boxes. "Given the current macro backdrop and remaining uncertainties, value sectors with defensive characteristics such as financials and green energy are also likely to get traction with investors," says Kat Kravtsov, capital markets director at PwC UK.

For Chan it is ESG that makes IPOs appeal. "Investors are likely to be more interested in companies with an ESG concept and those that can demonstrate the adoption of AI application into the business models and operations," Chan says.

Importantly, more than ever, Kravtsov says: "Investors are focused on profitability, cash generation and, ultimately, price range relative to peer valuations in their investment decision process."

And Lund-Yates notes how investors are shaping the IPO market. "It is important to consider that investor preferences towards high-growth, disruptive companies fuel enthusiasm for IPOs." That investor appetite for growth stocks seems key, as it is an area that continues to grow.

It does mean that the IPO market could well not just be back with a bang, but also much improved and nuanced.

The impact of the pandemic may now be in the rearview mirror, but other significant concerns have lingered in the insurance-investment world.

In 2023, Goldman Sachs Asset Management published its 12th annual insurance survey of more than 300 chief financial officers and chief investment officers. It revealed that 82% of respondents expect a US recession within the next three years.

While recessionary fears may have since receded to some extent, other thorny issues have hung around. Last summer, when assessing investment options for insurers, JP Morgan Asset Management commented that it had been "a tough environment for insurers to manage portfolios". This was attributed to inflation and interest rates, as well as recession risk.

There are also the unknowns to look out for. In Royal London Asset Management's insurance investment outlook for 2024, Piers Hillier, chief investment officer, said: "Every year, something will pop up that catches people unawares or causes a change in market behaviours or thinking."

Also, in its insurance outlook for this year, Wellington Management said that "insurers managing investments will need to be nimble, dynamic and forward looking".

Pain points

In the meantime, investors are still grappling with what's already in plain sight. According to Goldman Sachs' survey, inflation was viewed as the greatest macro-economic risk to investment portfolios with 81% of respondents anticipating that it would remain for the medium or long term.

INSURANCE: CHALLENGING TIMES

What will insurers invest in during what is set to be a difficult year and are they ready for any surprises? *Fiona Nicolson* reports.

And it is still one of the main topics for 2024, says David Thomas, head of insurance for the UK & Ireland at Schroders. "Uncertainty driven by the geopolitical and macro-economic conditions is giving insurers plenty to think about across their investment portfolios.

"Liquidity remains a key issue as they face higher redemption rates and lapse risk, driven by the cost-of-living crisis, coupled with managing unrealised losses from increasing interest rates: having sufficient levels of liquidity is still key to facing market shocks.

"Inflation poses challenges in properly reserving for those risks and in achieving real returns of assets over inflation," Thomas adds. "Countless hours are being spent, across the industry, discussing the persistence of inflation and its impact on rates and duration views." Christian Thompson, a director in M&G's insurance solutions team, also reflects on the issue of inflation. "Markets are sensitive to inflation data as they look to predict the size and timing of any 2024 rate cuts.

"While inflation is generally slowing across developed markets, employment figures remain relatively strong and central banks seem to be resistant to rate cuts until they are confident inflation is fully under control," he adds. "Therefore, we don't see any immediate rate cuts; however, insurers may be looking to take advantage of current yields given the expectation that they will fall over the year."

Sam Berman, director of UK insurance (asset management) for Allianz Global Investors, adds: "One of the most significant challenges for asset managers is seeking higher yields in a

higher-rate environment. This often introduces complexities and hurdles around structuring. However, the asset management and insurance industries are well-equipped to address these challenges." Geopolitical concerns around forthcoming voter decisions as well as ongoing conflict may add to macroeconomic uncertainty. "This year has been dubbed the 'election year' with more than 75% of democracies in the world going to the polls," Thomas says. "Although we can confidently predict the outcome of some presidential elections, the election in the US could go either way.

"The ongoing and escalating conflicts in the Middle East are alarming and alongside rising US-China tensions, the impact on markets could be abrupt, with supply chains put at risk, driving further inflationary pressures," he adds.

Considering other potential pain points this year, Thomas concludes: "Our investment teams spend a considerable amount of time looking at the probabilities of certain downside scenarios when constructing portfolios – be that sustained inflation driving higher rates for longer or a deteriorating economy causing an increase in defaults and credit risks.

"There is, of course, the unpredictable idiosyncratic risk that can surprise us all, but having robust processes in place to understand the impact to portfolios caused by known and unknown market stresses is critical."

A step in the right direction

Reforms to Solvency II, the regulation which sets out insurer responsibilities in areas such as governance, financial resources and reporting, is also high on the agenda this year.

Charles Moussier, head of EMEA insurance client solutions at Invesco, says: "After last year was characterised by the debate over the extent of the reforms, UK Solvency II remains the key area to watch in 2024. "The reform package encompasses legislation to reduce the risk margin, following the publication of draft regulations last June that proposed cutting it by roughly 65% or 30%, for long-term life and non-life insurance, respectively. Solvency II is also set to bring final rules on the matching adjustment (MA), as well as an attestation process for the amount of MA benefit being claimed.

"The Prudential Regulation Authority expects to publish final rules on the MA in Q2, coming into force at the end of June," Moussier adds. "Public finances remain constrained, and the incoming government is likely to look to the private sector as a source of significant new investment capital.

"It is hoped that Solvency II will contribute to this by freeing up billions of pounds of capital for investment, meaning that the insurance industry will be under pressure to demonstrate that it is working as intended."

Thomas says that insurers and insurance asset managers are working through how the reforms to Solvency II will affect asset and liability management, adding that the "devil is very much in the detail".

"The regulation allows for additional asset classes available for investing which we see as a step in the right direction."

Uncertainty driven by the geopolitical and macroeconomic conditions is giving insurers plenty to think about across their investment portfolios.

David Thomas, Schroders

Private interests

Considering how asset allocation might look this year, Thomas says: "As long-term allocators of capital we wouldn't expect wholesale changes to insurers' strategic asset allocation.

"We expect, and are seeing, insurers look at tactical and relative-value opportunities across asset classes such as agency mortgage-backed securities, for instance, which offer limited exposure to interest-rate changes and credit-spread moves."

Allocation to private assets also featured in Goldman Sachs' survey, which reported: "Despite growing worries about a US recession and rising geopolitical tensions, investor risk appetite remains healthy, with continued interest in the private-asset landscape."

Thomas agrees that illiquids could stand out. "Private assets saw a slowing down of deployment during the recent rate hikes as insurers reassessed their incremental value," he says. "But as increased rates become the norm, we expect investors to look again at the outsized returns on offer through private assets."

Nick Humphreys, managing director of global insurance at Man Group, also anticipates an interest in private markets, but only after they build a liquidity buffer. "In the current macroeconomic and geopolitical environment, we expect insurers to take advantage of elevated rates and focus on high-quality, liquid fixed income, holding more of a liquidity buffer than before – particularly as the cost of holding liquidity is currently at a post-global financial crisis low. Beyond that, we expect to see

Private markets remain a major area of interest for insurers as they look to access illiquidity and complexity premia whilst benefiting from increased diversification.

Chris Howells, Macquarie Asset Management

insurers continue deploying selectively into private markets with a particular focus on private-credit strategies," he adds.

Opportunities

Looking at where opportunities may emerge this year, Chris Howells, head of international insurance solutions at Macquarie Asset Management, says: "Private markets remain a major area of interest for insurers as they look to access illiquidity and complexity premia whilst benefiting from increased diversification. There is also a greater opportunity to invest in energy transition-related projects as more of these come to market and are made accessible in co-investment or fund structures."

Thomas adds that the key objective for insurers is managing their core fixed-income assets prudently and choosing the right credits to avoid unrealised losses. "The good news is that those assets are offering much higher yields than they have done over recent times," he says. "It remains a critical role of insurance asset managers to ensure a balanced portfolio that offers yield enhancing, capital-efficient opportunities, while managing downside risks effectively."

Paolo Gazzola, head of insurance advisory for EMEA at DWS, says: "Within fixed income, covered bonds are currently an attractively priced area of the market. Investment-grade corporates also have re-established their role as income enhancers, with 70% of the issues providing coupons above 3%, although we believe credit selection in 2024 will be key, in order to extract the most return per unit of economic and regulatory risk."

Eric Larsson, managing director and co-head of Alcentra's special situations team, says: "We will see economic fallout from the dramatic increase in global interest rates, regardless of whether we're technically in a recession or not and that will lead to an increase in the supply of opportunities in our market. The opportunity that presents for insurance investors is already here – they can invest in a portfolio of around 30 senior secured loans and high-yield bonds, with an all-in return of around 25% and a running yield of 8% to 9%. We have not seen that in the last 10 years."

Berman has observed rising interest in another potential opportunity. "We are witnessing increased interest in trade finance on the back of a move away from pure cash. It's an interesting asset class that comes in a multitude of forms, including risk profile, underlying exposure, duration and so forth," he adds. "The insurers we speak with are interested in accessing ultra-short-duration trade-finance receivables to give cash-plus returns, providing rate protection and yield pick-up."

ESG and impact investing are also still very much on the radar. Goldman Sachs' survey found that almost all (90%) of respondents were considering these factors in their investment decisions. "Impact investing, investing predominantly in private assets, that offers strong investment returns and provides an environmental or societal benefit, is another area that is getting more focus from investors and is one we believe will continue to offer investment opportunity and gather momentum," Thomas says.

Bringing in the professionals

Some insurers prefer to outsource investment to third-party asset managers. And when they do, they have a specific criteria in mind. According to Goldman Sachs' survey, their top consideration is differentiated methodologies and capabilities, with performance a close second.

Thomas says: "We are seeing an increased number of insurers consolidate their assets to a specialist insurance asset manager, who are able to understand the investment challenges and look across the whole balance sheet to offer more efficient investment solutions."

The question of resourcing could be a factor in their decisions too. Ghislain Perisse, global head of insurance solutions at Fidelity International, says: "Our 44 credit-research analysts follow a maximum of 20 to 30 corporates each, whereas in some insurers there might be two bond managers assigned to follow 250 corporates. As another example, on the private debt side, to undertake direct lending, you also need 20 to 30 analysts.

"In both cases, this could be very expensive for an insurer, so it might be worth partnering with an asset manager," he adds.

Whether an insurer appoints an asset manager or decides to manage their portfolios in-house, they need to be equipped to face growing economic and geopolitical uncertainty.

This is set to be an "interesting" time for insurance investors.

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pi ESG CLUB

The loss of natural capital not only impacts the environment; there are also economic and social consequences. This month's ESG Club looks at the real-world impact of the ecosystem's destruction and what pension schemes can do to help save it.

Members

BlackRock

NEWTON Investment Management

PENSIONS AND LIFETIME SAVINGS ASSOCIATION

MORE ASSET OWNERS TO SET GREEN TRANSITION TARGETS

Hitting a net-zero target is not easy, finds *Andrew Holt*.

A quarter of asset owners intend to set a formal net-zero commitment within the next 12 months, according to a study.

Research company Cerulli found that while 14% of asset owners have a formal net-zero commitment, an additional 25% plan to set one this year.

Specifically, almost a third (30%) of institutions are investing in strategies that support the transition to a carbon-neutral economy, and 36% plan to invest in these tactics within the next year.

As expected, many are moving away from coal, gas and oil, as half of the institutions surveyed say they will either divest (29%) or plan to divest (21%) from fossil fuel funds.

But even with a rising interest in sustainable investments, fossil fuel funds remain prominent due to their high returns.

One interesting statistic from As You Sow, a not-for-profit that promotes corporate social responsibility, reveals that 19% of the market cap of US fossil fuel companies comes from investments in US 401(k) accounts and individual retirement accounts.

Now, institutions are enacting these changes in order to prioritise and address climate risks, with 61% saying the issue of climate change is the top theme in their responsible investment strategy, revealed Cerulli.

New kid on the block

Despite their determination, investors continue to face difficulties when analysing the carbon footprints of underlying investment portfolios.

Inevitably, the lack of climate transition-related data has been consistently cited as a challenge for investors in understanding which companies are being transparent and dedicated to their climate change commitments.

However, there could be hope here. A new platform called the Net-Zero Data Public Utility database is planning to enter the market to hopefully once and for all establish reliable and accessible climate data across multiple industries.

That would address many of the issues investors have.

The database comes with some big names attached: formed by Emmanuel Macron's and Michael Bloomberg's Climate Data Steering Committee, it is designed to be integrated with the UN Framework Convention on Climate Change's Global Climate Action Portal, which identifies how companies, investors, organisations, regions and cities are engaging in global climate action.

As more investors re-examine their contributions to climate change, Cerulli said it expects to see a rise in collaborations that promote transparency when analysing climate-related funds.

A new framework

The survey's findings come as GLIL Infrastructure, a £3.6bn investment fund, revealed that it has adopted a new investment management framework to help it become net zero by 2050.

The adopted approach – the Institutional Investors Group on Climate Change (IIGCC) Net Zero Investment Management (NZIM) framework – sets out clear methodologies and approaches for investors to align their portfolio goals with the Paris Agreement, supporting them to make informed decisions and work towards achieving net-zero global emissions.

The NZIM framework was published in March last year and GLIL was one of the first investors to adopt its guidance for infrastructure, which builds on IIGCC's broader NZIM framework.

It is said to be the most implemented net-zero methodology for investors across all financial institutions within the Glasgow Financial Alliance for Net Zero.

The GLIL executive committee said it has worked "swiftly to select the new framework" to support the business with structuring its net-zero strategy and to allow for a consistent framework across its portfolio.

GLIL believes the NZIM approach will enhance its work in the energy transition by providing further support for its existing portfolio companies to ensure they have achievable net-zero pathways.

Beth Breen, ESG analyst at GLIL Infrastructure, said: "As a fund which delivers valuable investment into critical infrastructure projects across the UK and beyond, we know it is our responsibility to ensure that net-zero commitments are carried out within an effective strategy to achieve our 2050 targets.

"We believe the NZIM framework will allow infrastructure investors to bring further substance to their net-zero ambitions in a sector where it has been largely lacking.

"Our adoption of this new framework aligns with our members' commitment to driving the energy transition towards a sustainable net-zero economy."

GLIL is the partnership of UK pension funds specially designed to help pension fund members tap into the stable, inflation-linked returns that infrastructure investment offers.

It manages £3.6bn of committed capital, with more than £3bn deployed into a portfolio of infrastructure assets spanning renewable energy, battery storage, regulated utilities, ports and logistics, trains, hospitals and schools.

GLIL's focus on the energy transition can be seen in the fund's latest investment in a portfolio of 247MW of operational UK solar assets.

ESG INTERVIEW – KEITH GUTHRIE

"I prefer sustainability to ESG."

The head of UK sustainability for Now Pensions and Cardano talks to *Andrew Holt* about making a real impact, the systemic challenge in addressing sustainability and learning the lessons of collaboration.

You took up your new role in December, but you came from within the organisation. Despite knowing the operation, how would you describe the first few months?
Intense is the word I would choose. There is a lot going on and I took this role on because of that. It is an opportunity to add value in sustainability, not only just in the context of Now Pensions, but also in the wider industry, where there is an opportunity to influence organisations and individuals to have clearer thinking about how to tackle sustainability.
I am very much a first principles person. That is what I like doing.

What are your ESG and sustainability priorities?
There are quite a few things on the go at the moment. There is a lot of industry reporting and development around the Task Force on Climate-related Financial Disclosures. That is more the reporting function. What I want to focus my efforts on are where we can get up close and make a difference.
In the case of Cardano, it is working with all the different defined benefit pension funds we operate with. In the case of Now Pensions, it is working with the trustees on the on-going development of their sustainability efforts. What can we do in the portfolio that will improve member outcomes? The foundations are there already.

How do you view the Now Pensions approach to sustainability?
The trustees are engaged. That makes my job a lot easier. Their belief in sustainable investment needs to be tackled from financial risk and real-world impact perspectives. Having clarity of both in our investments is an important connection.
That is at the heart of what I believe is how sustainability should be done. It is where much of the industry gets it wrong, because it is usually about the risk perspective, which isn't terribly helpful.

Does the industry get lost on the real-world impact?
Few organisations set real-world impact as an objective. Therefore, they can end up getting themselves in knots. There is a lot of tick-box exercises going on.

How can that change?
I hope more will adopt a dual mandate. We define it as assisting in the transition towards a more sustainable society – which comes with all the environmental and social issues. That is how we define our real-world objective.

How central is sustainability to Now Pensions' investment approach?
It is hugely central. It has grown over time. We run the whole portfolio on a sustainable basis. The trustees then decide which portions of the portfolio have a specific sustainable objective – that is about 82% of the portfolio.
About 17% of the portfolio is made up of green bonds, while the equity portion has a growing allocation to green strategies.

Now Pensions has identified three sustainability priorities: climate action, the living wage and gender equality. Why are they so important?

Those are the trustees' themes and objectives and tied to our membership because it will make a difference to their lives. Two are social – the gender equality and the living wage – and then the climate focus, which we approach quite broadly.

Biodiversity feeds massively into climate. In our equity mandates there is a focus on deforestation and engaging businesses on the issue. The trustees have signed up to the PRI's Spring initiative, which is around deforestation.

What is the biggest challenge for investors who are committed to sustainability?

It is around how to do it well. People always say there is a lack of data. In some areas there is, but in others it is a lot better. You use what data you can. But you cannot stop data from making sure you have an influence and doing the right thing on sustainability.

One challenge is governance, in that you want to make sure the managers are aligned with the trustees and their beliefs. And on stewardship, it is about being part of the right alliances to do the right sort of engagements.

The relationship between Now Pensions and Cardano is reasonably unique. What, for you, are the benefits and flaws of such a relationship?

It is unique. The benefits have been in the ability to align what the trustees are looking for with what is executed. We have spent a lot of time understanding the trustees and what they are looking for.

A strength is the strong independent governance where the trustees have their own independent advisers. This creates a good dialogue. We worked together on measuring the decarbonisation in the portfolio by putting in place a framework that monitors how that is going versus the broader market.

It is also what I can bring to the role. I have a lot of experience with the group and I sit between the businesses. I need to know what is going on from an operational perspective and present to the trustees that side of the business.

Is there any time when there is conflict, where Cardano wants to do one thing and Now Pensions something else?

What we are cautious of is having good governance in place. If there are decisions where there is a conflict of interests, then Cardano leaves the room and the decision is made by the Now Pensions' trustees. So it is clear how potential conflicts are resolved. But it hasn't come up as an issue. Now Pensions works well with Cardano, the advisers and trustees.

Is the relationship therefore like an outsourced chief investment officer (OCIO) relationship?

You could say it is a bit like an OCIO. It is definitely an asset manager relationship. Cardano is not the adviser but works closely with the Now Pensions' trustees to devise the investment phases. And the trustees are very much engaged, particularly when it comes to sustainability. They challenge what we are doing in this area.

Cardano has the responsibility of appointing the asset managers. The trustees don't have that responsibility, but don't shy away from asking questions about it.

Cardano is also focused on impact in the portfolio. That involves engaging with

third-party asset managers to up their standards. There are also in-house teams at Cardano managing assets directly according to the sustainability standards set.

And those sustainability standards are set by Cardano?

It is double layered. Cardano has its own sustainable investment policy. This drives its internal strategies. Now Pensions appoints Cardano to manage the assets, which are managed in line with Cardano's policy. Now Pensions' trustees then add their sustainability priorities, and it gets implemented by the Cardano team.

The term ESG has come under criticism of late. Do you understand those criticisms?

It has become a real hot potato, particularly in the US. It has stopped being a description of investment risk assessment and has become a political term. I prefer sustainability to ESG. Our trustees believe sustainability is about the transition, not just about focusing on companies that are not truly green.

We have a large proportion of the market that has a negative impact on the environment and we need to figure out how it gets positive: things like airlines and cement companies. These companies are not going to disappear.

What we need to do is work together with them towards what a good transition plan looks like. So thinking about sustainability when investing across that spectrum.

Our trustees believe sustainability is about the transition, not just about focusing on companies that are not truly green.

Where does this leave ESG?

We may have an explicit bifurcation in the market, between investors who only have a financial risk ESG objective and investors who say the impact is more important.

I hope more and more of the market adopt that second approach. The real impacts are systemic and matter to long-term outcomes.

What has been the biggest change in how investors approach sustainability during your time working in this area?

It started off as a risk integration problem. But the biggest change is understanding that these issues are systemic. They are bigger than just being tackled at a company level. Governments have a huge role to play.

I also think collaboration has grown and individuals and organisations are figuring out how to do that better.

You mentioned the importance of government, how do you view the various initiatives from government and supranational bodies when it comes to sustainability?

Government has a huge role to play. They regulate industries, which is interconnected to sustainability. For investors the key challenge is that we are investing over the long term, which is why we take the systemic approach over the long-term risks we are exposed to.

What is important as an investor is: where I am investing? Do I understand the rules of the game? So what is important is that government keeps a level of consistency in its approach. If things change, you understand the impact on the risk premium. So government needs to give certainty of trajectory on sustainability.

What did you make then of Rishi Sunak and Keir Starmer backtracking on their ESG commitments?

That backtracking creates uncertainty and increases the risk and cost of making sustainable investments. But we have to also work within an economic reality. What is unhelpful is the mixed messages on the trajectory of travel.

Why is sustainability so attractive to you?

It has been a wonderful journey for me. I have, as I said, always had a first principles approach in how to figure out how I can make a real difference to our business and contribute to the world. There is still a lot of thinking that is still unclear and therefore there is a lot I can contribute.

Where do you aim to take Now Pensions on the sustainability front?

We have done a great job. We had a strategy review over the last year to push sustainability in all parts of the portfolio.

There are parts of the portfolio where it can go further. We have been talking to the trustees about impact investing but haven't worked out yet how to do that.

The cool parts of the portfolio are the green bond investments. The equity investments needed substantial change after the review. The equity portfolio now has real-world impact at its core, but we need to think about how to push it further.

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

If I look back on my younger self it would have been to understand the collaboration aspect earlier. I was like, 'I am smart enough to do this myself'. And that then becomes an appreciation of the team I am working with.

Mental health is also important to me. So a real appreciation that this not just a numbers and mathematics game, it is a real-world game, or not even a game, its people's lives.

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1 Source: BlackRock as at 30 June 2023.

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NATURAL CAPITAL: STAYING ALIVE

You can't fight climate change without a vibrant ecosystem, and you can't have a vibrant ecosystem if you have climate change. *Mark Dunne* looks at how institutional investors are tackling the problem.

Summer in Australia is a mixture of joy and despair. Alongside barbeques on the beach and playing cricket the sky often turns black from the bushfires that sweep across the country.

Such events are an annual occurrence, causing widespread destruction. Indeed, 10 people lost their lives and 170 homes were destroyed in December when fires engulfed almost 1.5 million square kilometres of bushland. Above average temperatures and below average rainfall were blamed.

Climate change is lighting the spark on Australia's bushfires and lives are being lost, but its impact on the natural world is creating other threats to life.

Extinction list

A chubby frog, a broad-toothed rat and various types of crayfish are among the 144 animals and plants that were added to Australia's threatened species list last year, bringing the total to more than 2,200. The list is growing due to habitats coming under threat from the destruction of land in the country, such as from bushfires.

This is a big issue as animals and plants are part of the natural capital that supports human life. Water, soil, coral reefs and bacteria are also elements of the ecosystem that provide us with nourishment, fresh air and medicine. The loss of this natural capital can lead to famine, drought, poverty and lower life expectancies.

Yet the biggest threat to such biodiversity are people, specifically in how we manage land. Ploughing fields to grow food, for example, may mean animals, plants and microbes are forced out of their natural territories or face extinction.

Pollution (including fertilisers), over-fishing, hunting, animal farming and human construction are other threats to the ecosystem, which could result in the loss of food and medicine as well as increasing the risk of people catching diseases from migrating animals.

We have already reached the point where we are exploiting nature faster than it can renew itself, according to the UN's Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services.

Natural defence

Climate change is another aggressor. Rising temperatures, changing rainfall patterns, extreme weather events, droughts, floods and bushfires are affecting ecosystems by changing what can grow and live in certain places.

So some plants, for example, are unable to flourish, while rising temperatures have seen the number of coral reefs almost halve in the past 150 years.

Yet a vibrant ecosystem is the natural defence against the impact of climate change. Plants, the ocean and soil remove carbon from the atmosphere, but deforestation transforms carbon sinks into carbon emitters. It needs to be the other way around.

It's not just about trees. The World Bank says that 85% of wetlands, such as carbon absorbing salt marshes, have disappeared. Pollution, agriculture and freshwater being diverted elsewhere are among the reasons why.

Such loss is a huge dent in the fight against global warming with estimates suggesting that natural capital can provide 37% of the mitigation needed to achieve the Paris Accord's 1.5-degree warming target by 2030, says Lee Backhouse, a senior responsible investment manager at Scottish Widows. "We have become more aware as a society of the connection between nature and climate change," he says. "That the two are inextricably interlinked, are mutually reinforcing one another.

"We know that the environmental processes that biodiversity supports, ultimately support the fight against climate change."

So investors are not going to achieve carbon neutrality if they ignore nature. "We need to bring nature in as part of that, because it is a major tool in reaching our decarbonisation goals, particularly when we consider that 37%," Backhouse adds.

The cost of nature loss

The impact of natural capital loss stretches beyond the environment in that it has serious consequences for the global economy. Indeed, more than half (55%) of the world's output, around $58trn (£46trn), is dependent on nature, according to PwC.

The World Bank believes that global GDP could lose $2.7trn (£2.1trn) by 2030 if ecosystem services collapse, such as pollination, carbon storage and timber provision.

However, it is some of the poorer countries in the developing world that could suffer the most if their ecosystem is not functioning as it should with the hit to GDP estimated at 10% a year.

One of the reasons is that the natural world provides people with a living, such as tourism. It can also give them a home. According to the World Bank, 1.6 billion people rely on forests for their livelihoods, while 300 million people live in them.

So there are also social benefits to having a vibrant ecosystem.

We have become more aware as a society of the connection between nature and climate change.

Lee Backhouse, Scottish Widows.

"You can't understate the social impact [of nature loss]," Backhouse says. "There is a huge drain on society as a result of biodiversity loss."

Backhouse adds that the social aspect is not just about earning a livelihood but being able to thrive in a particular area.

"We are incredibly lucky in the UK in that we don't experience wild events," he adds. "We get bad storms, but we are not at the forefront of the battle whereby the ecosystems that we depend on to live within are impacted.

"It is not just the earnings side, it is the continued survival of communities because of the increased risk from extreme weather of the loss of a particular material that we might depend upon for survival," he adds.

Hard targets

The world has had a difficult time in trying to protect its ecosystem. It failed to meet all of the 24 Aichi Biodiversity Targets, the deadline for which expired four years ago. Those targets included reducing pollution and deforestation by a certain level, while protecting 10% of the oceans.

A lack of financing was blamed. Indeed, the biodiversity funding gap is believed to be an average of $711bn (£561bn) a year between 2019 and 2030.

So institutional capital is needed to halt deforestation and pollution while protecting biodiversity against its other threats, providing greater access to freshwater and growing food more sustainably.

Despite climate change taking center stage in institutional portfolios, pension schemes are factoring natural capital into their decision making. One such scheme is the £900m Scot-

tish Borders Council Pension Fund. In January, it invested an undisclosed amount in a timberland fund. This is its first allocation to natural capital and aims to sell land and timber as well as carbon offsets.

Meanwhile, the £35bn Access pension pool has launched a global timberland mandate. The initial size of the portfolio will be around £300m.

Scottish Widows' approach has been to create a Global Environmental Solutions fund, which pushes the insurer's focus beyond climate change. "We are seeing an opportunity in the technological innovation that supports the preservation and restoration of biodiversity," Backhouse says. "Companies that are focusing on addressing pollution issues, not just those that are driving carbon dioxide down."

A benefit of investors looking at funding the transition is that the investment universe is huge, he adds. "Because economies are so dependent on nature, if you want to invest in the transition, the entire global market is pretty much an open field because every company needs to transition, every company has to address their environmental impact," Backhouse says.

High interest, low coupons

Then there are debt-for-nature swaps, which is where institutional capital encourages corporates to invest more in protecting the natural world in exchange for paying less interest on their borrowings.

In May 2023, Ecuador agreed a refinancing that will shrink the interest payments on its debt by more than $1bn (£793m) if it steps up efforts to support marine conservation around the Galápagos Islands.

The waters around the Islands are home to 3,000 species, 20% of which cannot be found anywhere else on earth, and inspired Charles Darwin's theory of evolution. But climate change and overfishing are putting pressure on this ecosystem.

Under the terms of the debt-for-nature swap, Ecuador will protect the Galápagos' marine reserves and promote sustainable fishing over the next 18 years to prevent habitat loss.

Barbados and Belize have agreed similar deals.

Legal & General Investment Management (LGIM) was an investor in the Ecuador deal. "Our financial systems are embedded within the natural environment, but the models that we use ignore it," says Wendy Walford, head of climate risk at Legal & General.

"We're extracting from the natural environment faster than it can replenish itself," she adds. "That's when the financial models need to be reappraised to understand how we make sure that we operate in a sustainable long-term way."

It is believed that the debt-for-nature market could soon exceed $800bn (£632bn), Bloomberg says, highlighting that putting a price on nature conversation is increasing interest in this space.

Risks and opportunities

Despite growing interest, barriers remain to investing in preserving natural capital. One of which is the lack of data.

"Being able to understand the impacts and dependencies of a financial portfolio on the natural environment means really detailed disclosures," Walford says. "That's where the Taskforce on Nature-related Financial Disclosures (TNFD) comes in."

The TNFD published its framework for nature-related risk management and disclosure in September to help organisations understand and report on their natural capital risks.

Perhaps this framework could encourage more institutional investors to factor biodiversity into their investment decisions. It is needed because there appears to be a lack of understanding in how to approach nature protection.

Backhouse says that those who decide to look at this issue in their portfolio, need to become "nature smart".

"To protect biodiversity, we need to understand biodiversity," he says. "We need to understand how it all plays out within the natural world.

"We need to break down what natural capital is to develop that critical capability to understand nature in order to identify the dependencies and impacts within a portfolio."

Backhouse adds that this lack of understanding of these risks is a barrier to pursuing opportunities in this space. Natural capital loss is a big issue; therefore some big opportunities will present themselves to investors as more and more people realise how crucial biodiversity is to fighting climate change.

If proof is needed, just look at the bushfires that engulf Australia each year and the resulting growing endangered species list.

Our financial systems are embedded within the natural environment, but the models that we use ignore it.

Wendy Walford, Legal & General

Bill Hughes is global head of real assets at LGIM

WHICH FOUR MEGATRENDS WILL DEFINE THE NEXT DECADE IN INVESTING?

Bill Hughes offers his view of the key drivers of performance into 2030 and beyond.

The plates underpinning the global economy are shifting.

Advances in technology, changes in population structures, geopolitical pressures and the drive toward decarbonisation are catalysing the development of new industries and rendering some assets and investment behaviours obsolete.

We believe there are four core megatrends that will influence the investment environment over the short, medium and long terms: **demographics**, **decarbonisation**, **digitalisation** and **deglobalisation**.

We expect these megatrends to be significant determinants of long-term investment performance and capital allocations in real assets for the remainder of this decade – and beyond.

There has always been a danger that megatrends are perceived as factors that matter tomorrow and not today. Investors will often guiltily put them on the back burner, knowing that they are important but allowing a lack of urgency and confidence to prevent them from incorporating them in their strategies.

However, change is accelerating. In just the past decade, in some countries we have seen the e-commerce revolution undercut the role of retail property. The office property sector is arguably undergoing a similar transition now, and allocations to it are increasingly being replaced by residential and industrial property.

In infrastructure, renewable energy generation has emerged as a material asset class, significantly displacing the role of fossil fuel related assets in many investors' portfolios. In parallel, private credit has emerged as a major asset class, partly boosted by long-term trends in banking regulation that have opened up potential opportunities for investors.

In this light, we believe investors may wish to consider constructing their portfolios to align with these megatrends – so here are the grand narratives we see as key determinants of performance:

1 Demographics

To an extent, demography is economic destiny.

Tailwinds deriving from the post-war baby boom played an important role in many major economies' development after the 1950s. Alongside a growing and healthier workforce, improving life expectancy and increasing urbanisation contributed to a period of reasonable economic growth, improving living conditions and rising disposable incomes.

In most developed economies, this demographic tide is now receding. Many face the dual challenges of shrinking labour forces and increasingly elderly populations. In the absence of the natural boost delivered by a young, growing population, these economies will need to increase their productivity to maintain living standards. This should in turn require greater adoption of technologies like robotics and AI that can take the place of a shrinking workforce.

These trends will create increased investment opportunities in emerging markets that display favourable demographic characteristics and growing labour forces. Weak fertility rates in high income countries and China means their share of the global population is expected to fall from 15.7% and 17.8%, respectively, in 2022, to 12.6% and 12.0% in 2060[1].

Meanwhile, sub-Saharan Africa's share of the global population is forecast to balloon from 14.6% in 2022 to 24.4% in 2060, with India and Southeast Asia's proportion remaining relatively stable over this period[2].

Meanwhile, in developed markets with ageing populations (and shrinking workforces) we see increasing physical and capital requirements for healthcare facilities and technologies, along with specialist accommodation for elderly communities. From a lifestyle perspective, we expect a continued growing emphasis on wellbeing and leisure, which should stimulate associated industries.

2 Decarbonisation

According to the Intergovernmental Panel on Climate Change (IPCC), the world will have to reach net-zero emissions by 2050 if we are to limit global average temperature increases to 1.5°C above pre-industrial levels. This is the threshold outlined in the 2015 Paris Agreement and committed to by almost every country in the world.

However, progress in decarbonisation has been patchy and global greenhouse gas (GHG) emissions are yet to meaningfully decline. One of the key challenges impeding progress is decoupling emissions from economic growth in emerging nations, where rapid increases in population and GDP have in recent decades been correlated with large expansions in GHG emissions released.

That said, decarbonisation has received significant policy focus in the EU and US, with considerable subsidies now introduced in support of constructing the infrastructure required for achieving net-zero carbon emissions. This is resulting in increased electrification as transport, home heating and certain industrial processes substitute burning fossil fuels for electricity. Simultaneous decarbonisation efforts in the power sector have accelerated the buildout of renewable energy capacity, mainly in solar and wind farms. Increased deployment of renewables is

placing pressure on power networks and demanding increased battery storage to deal with the intermittency of wind and solar output; addressing both challenges will require significant investment.

However, constraints in technology and remaining carbon budgets will likely lead to build-out of carbon capture and storage assets in certain sectors such as cement and power generation. This is likely to contribute to a greater focus on nature-based climate solutions that can assist in offsetting the impacts of hard-to-abate emissions.

3 Digitalisation

We define 'digitalisation' as the integration of new digital technologies into existing business processes[3].

These technologies have already radically altered business practices across many industries; the pace of development in big data, AI and machine learning is only likely to accelerate, with the scope of their impacts set to grow in parallel.

The growth of robotics, automation and AI-assisted design is likely to facilitate the modernisation of a range of industries and ultimately deliver broad-ranging efficiency savings. At the same time, the enormous computational demands of generative AI alone are likely to support long-term demand for associated services like data storage, cybersecurity, connectivity networks and hardware components. This should have follow-on impacts for materials, labour and real estate.

Digitalisation is also likely to reshape the global labour force, with some jobs replaced, other jobs requiring new skillsets to develop and deploy emerging technologies. As with demographics, this should create opportunities in further education and vocational training and could usher in a new era of productivity growth in economies burdened with unfavourable demographic trends.

4 Globalisation

We use the term 'deglobalisation' to describe the process of weakening global integration of trade, capital flows, people, intellectual property and co-operation.

At present we have seen a slowdown in globalisation, rather than a reversal. Nevertheless, the consequences of weakening global economic integration and political co-operation, particularly that between the US and China, represents a material shift in the world's economic landscape. Growth in global trade has stagnated following the GFC; with protectionism on the rise, as exemplified by the US' Inflation Reduction Act and weakening international trade in China, we believe that 'peak globalisation' may well be behind us.

We believe this will result in a permanent reconfiguration of supply chains, with resilience and diversification of supply prioritised over efficiency, and supply risks mitigated with larger inventories. We anticipate a trend towards onshoring, where supply chains that were once international can be reshaped to favour domestic production that carries less political risk, or friendshoring in countries with more stable relationships with companies' home nations.

In our view, this should translate into more real estate demand, with onshoring and friendshoring likely to be highly selective and focused on key strategic sectors where diversification of supply will remain a priority. Meanwhile, weaker global co-operation and heightened geopolitical tensions is likely to create more macro-economic risks and volatility, favouring more needs-based and counter-cyclical asset classes.

1) UN, 2022 Revision of World Population Prospects, https://population.un.org/wpp/
2) UN, 2022 Revision of World Population Prospects, https://population.un.org/wpp/
3) By contrast, we define 'digitalisation' as the conversion of information and documents from analogue to digital formats.

Key Risk Warnings
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PRIVATE EQUITY: LONG-TERM GAINS

Institutional investors are driving the growth of private equity, finds *Andrew Holt*.

Private equity within the institutional investment world continues to grow at a rapid rate. Many of the latest surveys show that pension schemes will either increase their allocation to the asset class this year, or at least maintain their exposure. This appears to show that they are strongly convinced by the performance and long-term potential of the asset class.

But how are institutional investors approaching such investments and what makes them so attractive?

Christian Dobson, alternatives portfolio manager at Border to Coast, gives an insight into why private equity is very much on the pension pool's agenda. "We have been making allocations to private equity funds for the last five years and it is an area we continue to see interest in from our partner funds," he says.

Dobson adds that private equity is attractive to institutional investors for a number of reasons. "Beyond long-term favourable returns, it provides diversification versus public markets and other asset classes."

He continues to explain that it can also provide access to fast growing companies. "This benefit is increasing as we are seeing companies stay private longer, supported by a growing private equity ecosystem," Dobson says.

In the driving seat

Another benefit when compared to public equities, where investors typically hold a minority stake, a large portion of private equity transactions are buyouts where firms take control of businesses.

"This allows them to be responsible for driving value creation through using their industry expertise to transform the business," Dobson says.

"Having control of businesses, as well as a longer-term time horizon, allows private equity managers to focus on strategic projects which may have less benefit for short-term earnings, but can drive long-term value. This can lead to favourable returns when businesses are exited," he adds.

Richard Moon, head of private markets at Railpen, agrees that private equity is significant for institutional investors. "Private equity is the largest component of our multi-strategy private markets portfolio," he says.

Aoifinn Devitt, chief investment officer of London CIV, is seeing a great demand for the asset class. "This reflects a trend around the LGPS and institutions generally, with the exceptions being defined benefit schemes which are in risk-off mode, but most institutions from small to large on a global basis are allocating more to privates. That is a trend we are participating in," she says.

She does note though that some of London CIV's clients are at different parts of their learning curve in regard to the asset class. "Some are well advanced while some are only dipping their toe on the water," Devitt says. "Catering for them is going to be a priority."

Meaningful ownership

For Moon, private equity has two big attractions. "It offers high returns and diversification to our public equity portfolio, particularly in the lower mid-market – £10m to £40m companies – where we are focused," he says.

In addition, there is an added advantage in that governance is generally strong in private equity-backed companies, Moon adds. "Management teams tend to be well aligned with private

equity owners through incentive plans that enable meaningful ownership in the portfolio companies.

"In private equity, company boards tend to be small and focused, with industry specialists supporting growth and other value creation initiatives," he says.

Eric Deram, managing partner at Flexstone, an affiliate of Natixis Investment Managers, also lists the benefits of private equity for institutional investors. "First and foremost, it is the superior performance over the long term against pretty much all other asset classes which attracts investors," he says.

Other attractions include a low correlation with public markets; low volatility; the vastness of the opportunity set allowing investors to build diversified portfolios; strong alignment of interest between management, fund managers and their investors; and financing the real economy.

"At the end of the day, 80% to 90% of companies around the world – the backbone of every economy – are held in private hands, including the large ones. Private equity provides vital equity financing to these companies," Deram says.

Private equity investing is an active, hands-on investment strategy.

Eric Deram, Flexstone

Barriers to entry

And for pensions funds there are other attractions. "Contrary to public markets, the private equity model enables management to take a longer-term perspective," Moon says. "This enables portfolio companies to prioritise value-creation initiatives, irrespective of timeframe, such as capex, which may not show up in earnings for several years."

John Eres, a fund manager in the private equity and impact division of M&G's private markets business, says there is more mileage from private equity that investors can exploit, but other factors are contributing to a lack of commitment. "We believe it is an established asset class, which is under allocated in many portfolios because executing and managing private equity portfolios is challenging."

Eres cites that over the last few years there has been a significant rise in interest given regulatory and technological change, but even against that backdrop, newer entrants to the space are mindful of the investment expertise, networks and operational platforms needed to execute strategies effectively.

"But given the increased regulatory pressure and expanding range of investment vehicles available, it feels increasingly incumbent on investors to consider whether allocations might be in the best interest of their stakeholders or clients," he says.

Trend setters

Institutions on the other side of the Atlantic are long-time supporters of private market assets. The reason, Eres says, are first investment principles. "By incorporating assets that have a low correlation to traditional assets and strong performance potential, they improve overall portfolio efficiency."

However, this has been taken to an extreme through the endowment model, where illiquid private assets make up to half of the portfolio. "Such high allocations can be taken because they have a long-term view and enough liquidity from elsewhere in their portfolio to meet their near-term needs," Eres says.

But the timing could be right for British institutional investors to take the private equity plunge, Dobson says. "Given fundraising challenges faced by many managers, this is a favourable time for institutional investors to be allocating capital to the space," he adds. "Investors are able to be increasingly selective around the funds they make commitments to."

It also means investors can negotiate access to managers that have historically not had capacity for new investors and can drive improved economics through fee negotiations. "Funds will often have completed seed investments which can be diligence by investors, reducing the blind pool risk of opportunities," Dobson adds.

Made to measure

There are though other aspects of private equity that are not being discussed but should be from an institutional investor perspective, Moon says, citing the importance of measuring returns.

"Assessing private equity's ability to generate attractive returns relative to other parts of private markets – such as debt – and public markets, lower leverage, in a higher interest rate/lower growth environment [is important]," he adds. "In response to this, we've improved the sophistication of our due diligence in assessing the various drivers of company-level returns."

It has been argued that private equity is one of the purest areas of active investing, especially where controlling stakes are held, and managers can forge transformative change to drive value creation.

"This is often hands on, resource intensive work with managers who are highly motivated to grow businesses," Eres says.

"Increasingly, we are seeing ESG as a core pillar of value creation as managers look out five years to what will make a portfolio company de-risked and attractive for future buyers.

"We see larger institutional investors investing alongside us with our preferred managers, but we also have conversations with more modestly resourced institutions," he adds.

As with most investments there has to be a level of caution amongst the enthusiasm. A well-formed established private equity portfolio can generate attractive returns from a diverse range of sources, but the journey to build it takes time and commitment, Eres says.

"It is reliant on deep expertise – from strong networks to originate access to funds and co-investments, to nurturing new managers as they spin out of established houses or to background checking when you don't have the same access to information that the public markets enjoy," he adds.

There has also been an increased amount of consolidation within the industry. That could be a plus but could see private equity become part of a wider, multi-layered private market approach.

"We are seeing increased consolidation, as managers bring on teams to offer a collection of private market strategies – something that we have done for a long time at M&G, offering not just private equity but also real assets, private credit, real estate and infrastructure," Eres says.

A dynamic market

But, as you would expect with a developing and growing market, there is a great deal of dynamism at play within the asset class.

"As the private equity industry opens up, it is also becoming more dynamic with the evolution of co-investments, continuation vehicles [where assets are transferred from a fund at the end of its term into a new fund] and growing liquidity in the secondaries market not to mention new regulated investment vehicles," Eres says.

"These developments are allowing for a more agile approach, but they do require expertise and understanding."

Exploring ways to achieve value within private equity, Deram believes that there are three methods. One, use leverage, which was effective over the last 10-plus years with the cost of debt close to zero, but less so today.

Two, multiple expansion. "This can be the result of market swings, which cannot be controlled, or a significant improvement in the quality of the assets," Deram says.

This latter point brings us to the third lever of value creation: operational improvement. "Some general partners have consistently generated value through this hands-on reshaping of companies' approach for decades," Deram says.

"Others are realising today that it is the only way to create value now that debt is expensive, to differentiate oneself and to generate consistent superior value. If a fund manager has the skills to reshape companies, he/she can do so over and over thereby generate sustainable superior returns," he adds.

More than half of the value creation Deram says he has delivered to investors is through funds of funds, secondary and co-investment strategies. It has historically come from cashflow growth of the underlying companies, which itself is derived from the ability of the fund managers selected to drive operational improvements and 'reshaping'.

Given fundraising challenges faced by many managers, this is a favourable time for institutional investors to be allocating capital to the space.

Christian Dobson, Border to Coast

Not for everyone

Of course, fees are a regular sticking point cited by some wary investors unwilling to take the private equity plunge. "One of the main debates about private equity within the institutional investor community in the UK is whether the performance fees are too rich for fund managers. For this reason, many do not invest in the asset class," Deram says.

He does though state it is worth highlighting two points in regard to this scepticism. "One, private equity investing is an active, hands-on investment strategy. To be successful, one needs to employ highly skilled investment professionals."

And the second point: "Private equity performance fees, unlike for hedge funds or other liquid investment funds, is only paid out to private equity fund managers after several years, and only once the capital gain plus a preferred return – generally 8% per annum – has been fully repaid to the investors. It is therefore subordinated to an 8% annual return to investors in most cases," Deram adds.

All in all, the case for private equity is significant, and one that is difficult for institutional investors to ignore.

THE FINAL COUNTDOWN

16%

The size of Europe's real estate debt funding gap, which is the sector's largest refinancing challenge. Loans for offices are a particular issue.

Source: AEW

69%

The level of defined contribution schemes expecting to increase their real asset exposure in the next two years, up from 51% a year ago

Source: Aviva Investors

65%

...of fund selectors expect greater stock market volatility this year than they saw in 2023.

Source: Natixis IM

$35.7bn

The capital backing emerging market securities during January, the third successive month of overall inflows.

Source: The Institute of International Finance

20%

The bonds in Europe that are classed as green social sustainable (GSS).

Source: MainStreet Partners

£425.4bn

The aggregate surplus of define benefit schemes in the UK at the end of January, down from £428.2bn a month earlier.

Source: Pension Protection Fund

€21bn

The net inflows into European ETFs during January.

Source: LSEG Lipper

55%

...of the world's GDP, or £46trn, is at risk from damage to the natural world.

Source: PwC

$2.8trn

The expected size of the private debt market by 2028, which would be a record high.

Source: Preqin

Quote of the Month

"Every pool has done something slightly different. Every pool has its own DNA."

Aoifinn Devitt, London CIV

PRIVATE MARKETS

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Alternative returns in unpredictable times

Shangri-La @ The Shard London, 25 April 2024

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