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WHAT NEXT FOR THE UK?

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WHAT NEXT FOR THE UK?

Britain faces some major challenges. This could also be a time of change, if the polls for July's general election are to be believed.

Rising economic inactivity from a growing sick list, an infrastructure upgrade needed to keep the country competitive, the continuing decline of the London Stock Exchange, de-carbonising the economy and fixing the overburdened NHS will all be piling up in the in-tray of whoever forms the government following 4 July's vote.

Yet the economy is improving. Inflation has dropped from a 40-year high to within touching distance of the Bank of England's 2% target and GDP growth has been revised upwards to 0.7% from 0.5%, before it is expected to expand by 1.5% in 2025. Such modest rises in productivity are unlikely to make much of a dent in the huge funding needed to tackle that to-do list.

So if the polls are correct that the UK is heading for a change in government in July, what could it mean for institutional investors?

In this month's cover story, we look at the environment that institutional investors may have to operate within during the next five years. Our coverage starts on page 18.

This edition also looks at the impact the rising cost of capital will have, how those looking to build a more sustainable planet are managing the backlash against ESG and if it is time for insurers to re-evaluate their portfolios.

We also sit down with Chetan Ghosh, the chief investment officer of Centrica Pension Schemes, to discuss living with an outsourced chief investment officer (OCIO) agreement, while Frances Deakin talks about Local Pensions Partnership Investments' approach to responsible investment.

We hope you enjoy the edition.

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IN THIS ISSUE

INFLATION REFUSES TO GET BACK IN ITS BOX

The issue of higher than expected inflation continues to hang around like an uninvited guest. *Andrew Holt* reports.

The UK's April inflation figure of 2.3% was a significant fall from March's 3.2%, but market forecasts had expected the consumer price index (CPI) to come in at 2.1%, proving inflation is still somewhat higher than it should be.

And worryingly, services inflation came in at 5.9% for April, down only a tad from 6% in March, according to the Office for National Statistics (ONS).

It presents an uncertain picture for investors and one that stretches a higher for longer scenario over an even longer timeframe. There are also nuanced and concerning ways to look at the numbers.

Tomasz Wieladek, chief European economist at T Rowe Price, said the services inflation number is important. "The Monetary Policy Committee (MPC) has repeatedly said services inflation will be an important indicator in understanding if domestically generated inflation is coming down in sustainable manner," he said.

For now, the MPC will try to wait until services inflation comes down, Wieladek said. "But if it does not, the MPC may have to hike again at some point," he warned. This could turn market expectations on their head.

Resilient inflation

Neil Birrell, chief investment officer at Premier Miton Investors, agreed that the numbers do not look good. "UK inflation is following the trend elsewhere and is proving to be more resilient than hoped," he said.

"It is not getting back to target as fast as the Bank of England (BoE) would like, which will probably delay the first interest rate cut," Birrell added. "The service sector has proved to be the sticking point and it will remain the bank's focus over the next month or two, ahead of a potential rate cut in the summer."

Zara Nokes, global market analyst at JP Morgan Asset Management, agreed that the picture is unlikely to provide a rate cut any time soon. "Critically for the policymakers at Threadneedle Street, services inflation – a useful gauge of inflation persistence – came in a lot hotter than its latest projections," she said.

In addition, Nokes added: "Given the recent divergence in opinions across the committee, the upside surprise in services inflation may dent the Bank's confidence that entrenched inflationary pressures are receding.

"While the Bank will still be able to take its foot off the brake this summer, a June cut now looks less likely. In our view, a cut in June would be premature; if the economy were slowing we would expect core inflation to follow headline lower, but recent data has shown activity re-accelerating."

World of inflation

Given this background, infrastructure has all the investor credentials in the higher inflationary environment, Blackrock said. "Infrastructure equity has reasonable valuations at higher interest rates, features steady earnings and offers cashflows often linked to inflation in what we expect will be a world of persistently higher inflation," said Christian Olinger, portfolio strategist at Blackrock Investment Institute.

Philippe Noyard, global head of fixed income at Candriam, said the situation has resulted in investors across most asset classes remaining on the edge of their seats, waiting for the fog to lift on the inflation and the larger macro-economic picture.

He said the situation for the European Central Bank (ECB) is different for that of the Bank of England.

"A consistent theme in the post-Covid economy has been a continuously stronger US economy compared to Europe. Nonetheless, surprises relative to expectations have recently been stronger in the eurozone than in the US," Noyard said.

"This should not jeopardise the disinflationary trend, and a first rate cut by the ECB in June is now a near-certainty," he added. "Further out, however, uncertainty is greater – and recent positive surprises will likely lead policymakers to proceed with great prudence."

And Noyard added: "In addition to the inflation and monetary policy dynamics, supply and demand should also be a tailwind for government bonds. We have seen important front-loading of supply in the first four months of the year."

"Based on differentials in the pathways for interest rates, we see opportunities in select currency pairs," Noyard added. "Mirroring our view on rates, we take a long euro versus pound sterling position. As we expect more rapid disinflation in the UK, the potential for dovish surprises is probably greater from the BoE than the ECB. As this is not counterbalanced by greater economic strength in the UK, we prefer to be short pound sterling."

INVESTORS TURN BULLISH ON FTSE100

Much investor debate surrounds the reasons for the UK market hitting new highs, finds *Andrew Holt*.

Despite an election, and the uncertainty that can come with that, at least in the short term, the UK stock market has seen a big rally, catching many investors off guard as the FTSE100 hit record highs.

But what is going on and what does it mean for investors?

One interpretation is that we could be seeing a shift in investor sentiment towards the UK. This is the view of Abby Glennie, deputy head of smaller companies at abrdn. "Flows have improved towards the UK market and UK sectors," she said.

This trend is evident in other ways, with many fund manager surveys placing the UK as the most favoured investor areas, she noted. "People were coming from low levels of allocation, but now they are saying that the UK is the place to keep your money."

In addition, manoeuvres within the wider economic environment are providing real benefits to the UK market. "We are now in a good point in the cycle whereby a decent chunk of industrial and domestic cyclicals are now lifting the whole UK market," Glennie added.

Takeover trend

That is not all. A broader trend of buyouts is also boosting the UK market, with takeovers across the UK market and across a whole host of different sectors, according to Laura Foll, a portfolio manager at Janus Henderson. "They are increasingly large companies as well," she said.

But there has been something of a more fundamental quantifiable change occurring as well. Roughly 25% of listed UK-company income is directly related to the UK economy and some perceived improvements in the economy seem to be flowing through into upward share prices.

A trend that has been identified elsewhere. For 2025, the IMF has said it expects growth in the UK to reach 1.5%, more than double the 2024 growth figure, as real incomes are supported by a slowdown in inflation and improved wider financial conditions.

But we should not get carried away: it is not all good news. The IMF still expects the UK economy's longer-term growth to remain subdued because of weak labour productivity and ill-ness-associated inactivity.

In addition, while positive, the story surrounding the UK's latest inflation figures suggests the Bank of England (BoE) are likely to push back further the timing of rate cuts.

As highlighted on page six, services inflation remains somewhat sticky and highly problematic.

It does mean that some market analysts who attributed the UK market rally to expectations of two UK interest rate cuts this year may well have to reconsider their perspective.

Falling short

There are other reasons we shouldn't get carried away by the UK market trend, warned Laith Khalaf, head of investment analysis at AJ Bell. He highlights that despite the fervor, the UK's markets have still fallen short of indices in the US, Europe and Japan.

Over the last 20 years, US stock markets have significantly outperformed their European peers.

In this way, the UK still has significant ground to make up on international peers to regain some real weight in the global stock market, noted Khalaf.

AJ Bell observes that the UK weighting in the MSCI World Index stands at 4%, down from around 10% a bit more than a decade ago. "Probably the biggest swing factor that could improve the UK's lot is a pullback in the US stock market," Khalaf said.

With a divisive US election ahead that cannot be ruled out.

Although in another twist, that could also have a negative impact on the UK. A bad spell for the US market could well have knock-on negative effects "for sentiment on this side of the pond," Khalaf added.

And there can be other reasons cited for the UK market upsurge. Some analysts have said the record high seen on the FTSE100 suggests investors are capitalising on the relative cheapness of the domestic market, at least compared to the US.

Within such analysis, UK small and mid-caps could be said to be trading at "large discounts" to large-cap peers and could be well benefit from eventual rate cuts – whenever that may be.

Investors possibly need to hold tight for more economic data and market updates to assess fully the UK market picture.

THE EQUITY-BOND DILEMMA

The equity-bond correlation is in positive territory, but that is likely to change, says *Andrew Holt*.

One of the big points of investor discussion has been the correlation between bonds and equities. The investor consensus is that the correlation should be negative. But that has not been the case more recently.

In fact correlations have sharply increased. Indeed, correlations between stocks and bonds edged into positive territory in 2021 and jumped up to 0.58 for the full year in 2022 and 2023, according to Morningstar.

The uptrend in correlations has been unusually dramatic but not unprecedented: as the stock-bond correlation has often been positive over multi-year periods, Morningstar said.

For example, the trailing three-year correlation co-efficients between equity and bonds were consistently above zero from August 1966 to August 1974, according to Morningstar. Stock-bond correlations were also consistently positive from October 1974 until late 2000.

William De Vijlder, group chief economist at BNP Paribas, said since 2000 the correlation has been predominantly negative, especially when official interest rates were at the zero lower bound.

Then during the Federal Reserve's latest tightening cycle, the correlation turned positive again, De Vijlder said. "This is reminiscent of what happened during the rate-hike cycle of 2004 to 2006. This is not a surprise: higher official interest rates cause an increase in bond yields and a decline in bond prices," he said.

Higher rates lower the net present value of future earnings and can cause a downward revision of these future earnings, and weigh on the risk appetite of investors, De Vijlder said. "For all these reasons, equity prices may decline, leading to a positive correlation with bond prices, which have also declined. Investors no longer benefit from a diversification effect."

A negative correlation is when equity prices decline, bond prices rise, and so bond yields fall. Those invested in both will benefit from a diversification effect: one asset declines in value but the other increases cushioning the impact of the other. This underpins the demand for bonds, even when yields are low.

Correlation inflation

Morningstar also looked at correlations over specific periods of higher inflation, generally defined as periods when year-over-year inflation increased by at least 5% and remained high for at least six months – and highly relevant for the current period.

Here, correlations between stocks and bonds rose during some, but not all, periods.

In general, correlations increased the most when inflation was high – in the double digits – and protracted, lasting at least three years. Going back further, the post-World War II era saw an unusually high spike in inflation, but the increase in consumer prices lasted only about a year.

More recently, surging economic growth in China fuelled rising consumer prices in 2007 and 2008, but inflation remained below 6% and lasted less than a year.

The most dramatic correlation upturns took place from February 1966 to January 1970 – driven by low unemployment and surging economic growth – and February 1977 through to March 1980, driven by soaring oil prices and expansionary monetary policies, Morningstar said.

Correlations ended up in a similar range – 0.26 and 0.28, respectively – during both periods. Thanks to the rapidly shifting landscape for interest rates and inflation, the recent upturn in stock-bond correlations has been even more pronounced.

There is a lesson to draw from these patterns, according to Morningstar's Amy Arnott, which has implications for investors today: the environment for inflation and interest rates has fundamentally changed.

The idea being that as long as the outlook for inflation and interest rates remains uncertain, the correlation between stocks and bonds will probably remain higher than in the past. Indeed, correlations between stocks and intermediate-term government bonds stood at about 0.6 for the trailing 12-month period through to the end of April this year.

Investors ironically can contribute to this, as they often hold cash over financial assets during a slowdown, leading to a sudden rise in equity and bond risk premia and conditions that push equity-bond correlations into positive territory.

It doesn't necessarily mean investors should avoid bonds. Stocks and bonds tend to move more in tandem during inflationary periods, but bonds can still provide significant diversification benefits, as well as play a critical role in providing a counterweight and reducing risk at the portfolio level.

But, this picture could all change. "We see the bond-equity correlation shifting back to negative this year," said George Saravelos, global head of FX research at Deutsche Bank.

This is a perspective shared by De Vijlder. "Based on past experience, one would expect that, as the Federal Reserve starts cutting rates later this year, the bond-equity correlation would turn negative again," he said.

This could reflect a benign scenario of equities rising due to lower rates, whereas bond markets have already anticipated the policy easing and start to focus on the positive impact of rate cuts on the growth outlook. A less benign scenario would consist of a rallying bond market because the economy turns out to be weaker than expected – hence causing equities to decline. "This scenario, in our view, is less likely," De Vijlder said.

BIODIVERSITY LOSS – WHY SHOULD INVESTORS CARE?

Edward Lees and Ulrik Fugmann, co-heads of the environmental strategies group, and Alexandra Matthews is an environmental analyst at BNP Paribas Asset Management.

Human-driven pollution, climate change and population growth are all proven causes of the on-going loss of biodiversity. Global gross domestic product is estimated to total around $44trn (£34.6trn). Of this, more than half is reckoned to rely, to some extent, on biodiversity[1].

Biodiversity refers to the variety of living species on Earth, all of which work together in ecosystems, like an intricate web, to maintain balance and support life. Human life is fundamentally linked to biodiversity: it provides necessities such as food, air and shelter and plays a prominent role in economies, society and culture.

However, pollution, climate change and population growth are rapidly depleting biodiversity. Governments and other parties have started to respond. The European Union's Sustainable Finance Disclosure Regulation, the Global Bio diversity Framework and the US Inflation Reduction Act are all example of collaborative efforts to preserve nature.

Why should investors care?

History has shown that when society faces large structural problems, companies that help to solve these problems can do well.

Underscoring the value of investments in nature, the World Bank has found that every dollar invested in the water supply could generate seven dollars in return from related beneficiaries.

For investors, the key will be to identify companies that are related to solving nature-related problems and receiving capital that will be directed at the solutions.

The biodiversity finance gap is valued at about $700bn (£550bn) per year[2], so we believe it is a priority to scale up and effectively allocate biodiversity-positive finance. There are multiple approaches to this, such as excluding investment in practices and industries that harm biodiversity and implementing an investment criteria that favours nature-positive solutions.

What are the challenges of investing in biodiversity?

Concerns over greenwashing are rising within biodiversity listed equity funds. The challenges of investing in biodiversity in the public space are:

The limited universe of listed biodiversity-focused companies

Listed equity biodiversity funds face a unique challenge. Unlike areas such as renewable energy that have clear links to decarbonisation, listed companies rarely have core business activities that directly conserve or restore biodiversity.

Many public companies claiming to be nature-positive achieve this through how they run their operations, not through their business activities.

While some firms integrate biodiversity into their corporate sustainability initiatives or have projects that loosely address biodiversity goals, these are commendable, but often secondary efforts.

However, there are also public companies whose main activities have a meaningful link to biodiversity.

They could include innovative solution-providers specialising in removing salt from seawater, forest management, smart agriculture and recycling technologies, for example.

Keeping this two-way split in mind is helpful when evaluating biodiversity-related investment strategies in the public space carefully and transparently.

Measuring biodiversity impact

Measuring a fund's positive contribution to biodiversity is inherently challenging. The most common tool, Mean Species Abundance (MSA), has limitations. Most companies do not report on biodiversity meaningfully and, as there is little consistency across companies, making comparisons hard. Finally, biodiversity holds intrinsic value, which is difficult to realise and quantify through traditional metrics.

Aiming for ecosystem restoration

A BNP Paribas AM strategy focused on ecosystem restoration seeks to align with the United Nations' goal to return ecological functionality to degraded ecosystems. We believe that pausing and reversing the effects of the biodiversity crisis contributes to achieving this goal. This can be done through three key elements:

Focus on solution providers

Firstly, by investing only in companies whose products and/or services enable environmental solutions which can drive impact as well as achieve longer term sustainable, above-market returns.

Targeting reform in industries with a high biodiversity impact

We also target areas which have the largest negative biodiversity impact: consumer staples, materials, energy, industrials, consumer discretionary and utilities.

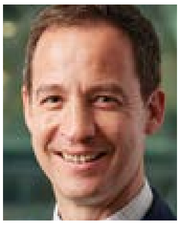
Engagement

Finally, through individual engagement and proxy voting, collaborative engagement, and public policy and advocacy, we support and collaborate with the companies we invest in to maximise biodiversity-positive solutions and operations. We work with the BNPP AM Sustainability Centre to drive and guide biodiversity-related engagement.

1) World Economic Forum, January 2023
2) International Finance Corporation, March 2023

PEOPLE MOVES

Now Pensions has a new director of investment after **Martyn James** joined the workplace pension provider.



James (*pictured*) joined from Mercer where he spent 22 years, including a decade as a partner in its UK defined contribution business.

James will lead the master trust's investment strategy, which includes enhancing the sustainability of the £4bn portfolio and strengthening their stewardship expertise.

Helen Dean has taken over as chair of the **Standard Life Master Trust**, which serves more than 300,000 members.

She took over in May, a month after ending her nine-year reign as chief executive of Nest.

Dean brings a wealth of experience to the master trust, which has included playing a lead role in the creation of auto enrolment and establishing the pension scheme which became Nest.

Victoria Barron's reign as head of sustainable investment at **Brightwell** has ended after four years.

The fiduciary manager, which provides services to the BT Pension Scheme, is not looking for a replacement as sustainability is being integrated throughout its investment team.

Elsewhere, master trust **Smart Pension** has appointed **Kim Gubler** as an independent trustee.

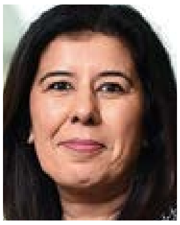
A founding director of the Pensions Administration Standards Association (PASA), and its chair since 2019, she has more than 30 years of pensions industry experience and has been an independent trustee director of the Crystal Master Trust.

"Her skills will be an invaluable asset as the industry moves towards consolidation, something we are keen to lead the field in," Smart UK's CEO, Jamie Fiveash, said.

Phoenix Group has named **Cecile Retaureau** as its next head of private markets.

She joins in August from UBS, where she is global head of cross-asset financing and fixed income. BNP Paribas and Credit Agricole also appear on her CV.

Retaureau will lead a team of 16 investment professionals across real estate, infrastructure, public finance, corporate credit and private equity.



Finally, professional trustee provider **Independent Governance Group** (IGG) has promoted **Priti Ruparelia** to head of defined contribution, replacing Dianne Day.

Ruparelia (*pictured*) has worked for the firm since last September. Before that she led Legal & General's defined contribution (DC) relationship teams. She has also set up DC schemes and transitioned schemes to master trusts status.

IGG representatives work on trustee boards that collectively oversee £40bn of DC savings for more than 3.5 million members.

CALENDAR

Topics for upcoming *portfolio institutional* events*

26 June
Industrial real estate roundtable

03 July
ESG Club Conference

10 July
Fixed income roundtable

September
DC and private markets roundtable

September
Demystifying Asset-backed finance roundtable

November
Insurance roundtable

*Subject to change

NOTICEBOARD

Kicking off this month's institutional investment round up is **Border to Coast Pensions Partnership**, which has launched two propositions that will increase its private markets exposure by almost £2bn.

The £40.3bn pension pool has allocated £1.2bn to a second Climate Opportunities offering, which backs projects and businesses that are working to decarbonise the economy.

Border to Coast has also invested £500m in a UK Opportunities strategy, which it launched in April to invest in housing, transport, energy and growth finance.

The pool now has £16bn invested in, or allocated to, private market assets.

The Environment Agency Pension Fund has invested £170m in the UK's renewable infrastructure.

The capital will be managed by the £1.35bn Greencoat Renewable Income LP, which targets wind, solar and bioenergy assets as well as technologies such as heat pumps and green hydrogen.

A £46m full buy-in of the **Lexmark Pension Plan** has been agreed with **Canada Life**. The plan is the retirement scheme for workers at the UK arm of Lexmark, a US printer and image product manufacturer.

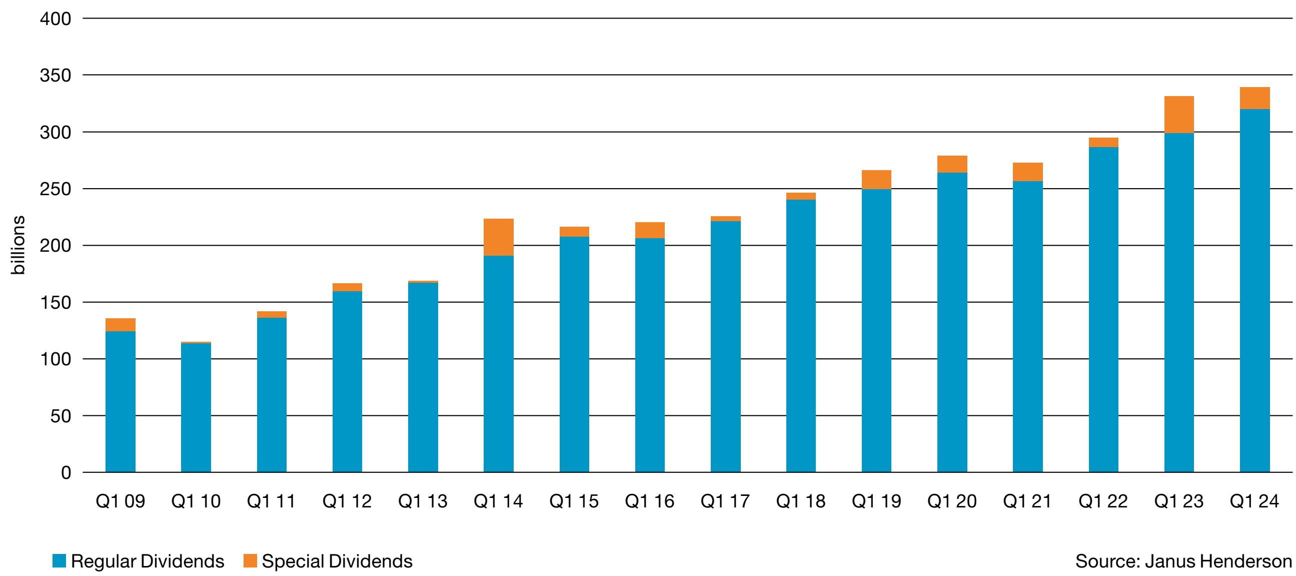
The deal removes longevity risk and therefore secures the benefits of all 177 members.

Finally, the trustees of the **John Turner Construction Group Staff Pension Scheme**, which is sponsored by a builder in north-west England, have de-risked the benefits of all 19 members after agreeing a full scheme buy-in with **Aviva**. The financial terms of the deal have not been disclosed.

The scheme will now proceed to full buy-out before being wound up.

THE BIG PICTURE: DIVIDEND MOMENTUM BUILDS AS RECORD YEAR EXPECTED

Global total annual dividends (US$ billions)



Source: Janus Henderson

Despite economic uncertainty, corporates are set to pay record dividends this year.

Investors are set to pocket more corporate earnings this year than ever before after a strong first quarter cemented expectations.

Boardrooms around the globe collectively handed $339.2bn (£266.3bn) back to their shareholders in the opening three months of the year – an underlying 6.8% jump in 12 months.

Such an improvement was expected and therefore supports Janus Henderson's forecast of investors receiving $1.72trn (£1.3trn) in dividends this year. This would be a 3.9% headline improvement on 2023's cash returns, equivalent to underlying growth of 5%.

Another positive sign despite the economic and geopolitical uncertainty is that first quarter payouts were 51% larger than in the same period in 2017.

We may have witnessed a 2.4% headline improvement on the same period a year earlier with 93% of companies increasing their payouts or holding them steady, but the level of growth fell six-fold. Indeed, a year earlier dividends grew by 12.5%.

Lower special dividends have been blamed and were expected. Such payments totalled $19.5bn (£15.3bn), down from $32.5bn (£25.5bn) during the same period last year. Volkswagen's sale of Porsche was one reason why one-off payments were higher last year, while we also saw the end of Moller Maersk's special dividends.

In the first quarter of this year, banks accounted for a quarter of global growth and 60% of payments came from North America, or $164.3bn (£128.9bn), which was a 7% rise on an underlying basis. The UK contributed 5% of the total.

Tech giants Meta ($1.1bn) and Alibaba paid their first dividend during the period, which added more than 1% to the total. Disney also recommended its first dividend since the pandemic.

Janus Henderson said that the "broad picture is one of continued dividend resilience". This is especially evident in Europe, the US and Canada.

One point of interest is that payments in Europe bucked the growth trend to drop slightly to $45.8bn (£35.9bn) from $46.7bn (£36.6bn). Janus Henderson blamed this on lower special dividends and "seasonal factors".

Linda Carmody *(pictured)* is senior relationship manager at Better Society Capital while Gemma Bourne is MD of property investment.

PENSION SCHEMES' ROLE IN TACKLING THE HOUSING CRISIS

Pension fund investment is needed to provide more homes and help tackle the UK's housing shortage crisis. In return, there is an opportunity for schemes to generate reliable returns while contributing to a solution to one of the UK's most pressing socio-economic problems.

Research we commissioned highlights the urgent need for longer-term social and affordable housing for the 104,000 households living in temporary, unsuitable accommodation across England.

This is set against a backdrop of needing £16.9bn to tackle housing undersupply. There simply isn't enough government funding to provide the homes needed and private capital is part of the solution.

We believe the evidence is clear – this is an investment opportunity that offers positive social impact as well as fair risk-adjusted returns.

When it comes to investing in social and affordable housing, one opportunity is homelessness funds, which acquire and refurbish properties.

These properties are then leased to homelessness charities and housing associations, which offer stable, affordable housing with wraparound care and support for the needy – a viable alternative to costly and insecure temporary accommodation.

One social property fund manager that uses this model, Resonance, acquired more than 1,000 properties in the decade to 2023. It has housed more than 3,300 people at risk of homelessness, including 1,607 children, during that period.

However, social and affordable housing is not just about shelter. It also gives families the stability to engage in daily activities that many of us take for granted – cooking a warm meal each night, maintaining secure employment and accessing healthcare.

That's why Resonance, alongside support services provided by its housing partners, saved the authorities £140m in temporary accommodation and other homelessness costs, such as employment support services, according to Alma Economics.

While the benefits for the UK population are apparent, social and affordable property funds also present a compelling opportunity for institutional investors. It has the potential to deliver long-dated income that has index-like characteristics, along with high levels of rent collection, low voids and high structural demand which creates a steady return.

These investments also exhibit low GDP sensitivity, making them a valuable tool for portfolio diversification. In fact, figures indicate that during the macro-economic turbulence of recent years, social and affordable housing proved more resilient than other real estate sectors.

Trustees know that financial characteristics are not the only factors when making an investment decision. Increasingly, members desire investment opportunities that contribute to a social good without compromising on their returns.

In this respect, investments in social and affordable housing are highly tangible and many members will appreciate that their savings are contributing to initiatives they can relate to.

To help measure and quantify impact, we created the Equity Impact Project in partnership with 14 fund managers as a sector-standard framework for measuring and reporting their impact.

Used against our own portfolio, we found that 65% of our investments tackling homelessness are in areas with the highest homelessness pressures.

While investing in social and affordable housing presents opportunities, it also comes with important considerations. Notably, investors have expressed concerns about reputational risk if their investment is badly executed.

This underscores the need for expertise, an understanding of the social issue and appropriate diligence when investing in properties intended as someone's home.

We already co-invest with institutional investors in social and affordable housing funds, leveraging a decade of experience in the sector to identify high-quality opportunities.

As trustees increasingly seek investments that reflect the values of their members, the appeal of these investments will continue to grow. With careful consideration and strategic partnerships, investors can play a pivotal role in addressing one of society's most pressing challenges while delivering reliable financial returns.

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WHY INVESTING IN RENEWABLES IS RISING UP THE AGENDA

Renewable energy is experiencing rejuvenated attention from investors, with pension schemes expected to increase allocation to the sector over the next few years as the global economy continues its ongoing transition to clean energy, with the aim of decarbonising the economy.

An overwhelming 95% of UK pension funds expect to increase their allocations to renewable energy assets over the next five years, according to research by investment consultancy, Alphareal.

So why is renewable energy looking like such an attractive asset class?

The UK government's net-zero commitment, implemented through increasing incentives and legislation focused on improving the country's energy infrastructure, is one of the reasons prompting asset owners to align on renewable energy investments.

Increases in regulatory pressures and continuing technological innovations are supporting the investment case for renewable energy assets by consolidating their necessity and feasibility.

Innovations across the energy industry are consistently reducing costs and improving efficiency, subsequently consolidating the viability of these investments. The portfolio diversification and climate risk mitigation that investments in renewable infrastructure offer continue to be effective ways to manage risk, in addition to opportunities that the transition to a low-carbon economy presents.

Though not an unexpected trend, the compelling factors behind the growth of renewable energy infrastructure are expected to underpin a period of continued growth for the sector.

So, what is the investment case for investing in renewables?

Overall, investments in renewable energy infrastructure help drive technological innovation and advances in clean energy technologies. Research and development in areas such as energy storage, grid integration, and renewable resource forecasting improve the efficiency, reliability and scalability of renewable energy systems.

Renewable energy sources are abundant, able to reduce dependence on imported fossil fuels and enhance energy security. By diversifying the energy mix and decentralising power generation, renewable infrastructure can increase resilience to disruptions and improve energy access in remote or underserved areas.

Additionally, renewable energy technologies continue to improve efficiency and cost-effectiveness, making them increasingly competitive with fossil fuels.

Investment in renewable infrastructure, such as solar, wind, hydroelectric and geothermal energy projects, help to reduce greenhouse gas emissions by displacing fossil fuel-based energy sources. This transition to clean energy is essential for mitigating climate change and meeting global carbon reduction targets.

While investing in renewables has a host of advantages, what should investors be mindful of?

Alongside technological innovation, the importance of due diligence cannot be overstated, as ESG alignment and regulatory compliance remain key metrics within any transition investment strategy.

The significant upfront investments that are often required for these projects can mean investors are required to take on risk early in a project's life. These risks can easily be realised by commonplace challenges to the sector, such as changes in government policy or difficulties in identifying and securing suitable sites. Increasingly, investors also need to consider the impact on nature as the investor focus moves towards a more holistic view of climate and biodiversity. Partnering with the right managers who have the necessary expertise is thus important.

Investing to generate positive real-world impacts requires a strategic approach to asset allocation and risk management, as well as strong responsible investment policies and stewardship practices.

Investing in renewable energy infrastructure can help achieve a sustainable, low-carbon future and provide social, environmental, and economic benefits. By channelling capital towards clean energy projects and supporting policies that facilitate their deployment, investors can play a critical role in accelerating the transition to a renewable energy economy and benefit from it.

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INTERVIEW – CHETAN GHOSH

"I do not want to say an OCIO is the nirvana for every scheme, but it works in certain circumstances, and works well."

Chetan Ghosh, CIO at the Centrica Pension Fund and now OCIO Schroders Solutions, talks to *Andrew Holt* about the scheme's OCIO two years on from its creation.

It is two years since Centrica entered into an OCIO partnership with Schroders. Is it working as expected?

Everything has gone positively from an in-house team perspective. I speak for the Centrica trustees, and it feels that they are pleased with the outcome of how the partnership has gone.

If we go back to the primary reason for the trustees entering into an outsourced chief investment officer (OCIO) partnership, it was to strengthen the business continuity and deepen the client team. We were a team of seven, sitting in Windsor, which is not the easiest place to get investment professionals to come and work.

We were getting sequential turnover and it was proving hard to find replacements. At times, it was taking a year from someone leaving to a replacement coming through the door. That is quite debilitating when you are a small team.

Fast forward to sitting within Schroders Solutions, which is the OCIO and fiduciary management part of Schroders, the team is more than 150 people, so we are well resourced with a deeper pool of people working on the portfolio. That part has worked well. And interestingly, our in-house team of seven are still here – another indication of the OCIO working.

The other thing that was important to the trustees was getting an operational set-up where the OCIO oversight was closer to the liability-driven investment (LDI) implementation. So without having a crystal ball, and foresight about the gilts crisis, the Centrica trustees recognised a way to strengthen operational processes.

Moving the LDI to Schroders, as part of the OCIO arrangement, has resulted in a vast improvement in the speed and real-time nature availability of management information in relation to the LDI portfolio. The OCIO partnership has therefore ticked all those primary objectives.

What have been the benefits and challenges of adopting an OCIO approach?

A real benefit is having that instant access to the vast investment resource within Schroders. We get a tremendous amount of support. We have direct access to the practitioners: for example, the people who manage equity and fixed income portfolios, a 50-strong team on ESG – things like that. As well as access to the research side, which we can plug into.

Less obvious, but equally important, is the legal aspect. Having a legal team which have done a lot of the same work we commissioned, means they can provide useful guidance immediately and at no additional cost.

On the challenging side, the big focus surrounded having a seamless transition. We ended work on the Friday as Centrica, and started work on the Monday at Schroders, but doing exactly the same thing. That process needed to be done effectively. We came through that well.

All in all, there were very little teething challenges. We needed to ensure we were aligned and adhered to the operational risk framework that a big firm like Schorders has, but this was an example of us benefitting from Schroders' comprehensive capabilities. Then of course it was integrating the team within the business. Which has gone well.

The other thing is as an in-house team [within Centrica] we were almost adjoint of the trustees, whereas now we are a service provider. The key thing was to make sure we got that subtle change correct and acted appropriately in this slightly different role. I think we have nailed it.

Was it slightly nerve wrecking or was it exciting moving to that transition?

Both. We felt like we nailed the preparation. But you are always nervous that something could go wrong. That said, we were confident that if anything were to go wrong it would be minor in nature. I cannot recall anything going wrong.

How long did you consider and discuss the OCIO before taking the plunge?

The process in totality lasted just under two years. At the time the trustees were considering it there hadn't been a UK corporate pension scheme announce an OCIO. So to the trustees it did feel like they were first movers in taking this step.

> **At the time the trustees were considering it there hadn't been a UK corporate pension scheme announce an OCIO.**

Have you had other pension funds considering an OCIO contact you?

Yeah. I always had those conversations on it before we did the OCIO and have carried on those conversations. Just by the nature that we have catch ups other pension funds do ask: 'how it's going', and 'what has the experience been like'.

On a practical level, who reports to whom within the OCIO structure?

The head of the OCIO is Neil Walton within Schroders. I report to him. And he also provides a lot of oversight on the Centrica account. The core of the Centrica team continue to report to me.

Presumably you are happy with the structure?

Yes. If you think about building a scaleable business you need a structure which takes on a degree of specialism. Going back to the old Centrica structure, I was effectively running a seven-person outfit. I oversaw investment strategy, the investment implementation and operations.

In a scalable business these are three distinct functions. You then have to get segmentation about who delivers what. Schroders has integrated OCIO arrangements really well, as they have flexibility and scale. It was the mantra of the Centrica trustees to have a seamless transition and that focus on business continuity.

You mentioned business continuity was central to the Centrica trustees' thinking behind embracing the OCIO approach. Did other ideas motivate your thinking?

It was business continuity and combining the LDI and OCIO oversight, which were the main drivers. Probably flowing from those two aspects it was also about getting optimal governance at the trustee level when making investment decisions.

Some asset owners suggest that going down the OCIO route means losing a central investment culture within the organisation: what would you say to that?

I would disagree. If I look at how we have been transitioned and been brought into the business, I view it as a thoughtful way, because as a team we have kept our culture and also integrated into the combined culture. We have benefited from the best of both cultures.

That is not necessarily going to be the case with every firm. The culture of Schroders was important. But it was about a central idea: we have to drive optimal client outcomes – how do we do that? I am not sure all organisations have that client focus.

What would you say to asset owners considering an OCIO?

You need to do what is right for your governance structure and circumstances of your scheme. I do not want to say an OCIO is the nirvana for every scheme, but it works in certain circumstances, and works well when it is appropriate. It is about working out what you need to achieve. These are big relationships. They have to be trusted partnerships and involve big amounts of money.

The culture, brand and philosophy we

have is to do the right thing by the client and these are important things. Those cultural aspects are probably not given enough weight in the [OCIO] selection processes. I would argue some companies should be red flagged on that basis.
The other aspect is around letting you have an open architecture portfolio. So you are not having your portfolio filled with products from the underlying asset manager.
For example, within Centrica the trustees decided to use Schroders for LDI, and two years on, this remains the key Schroders product in the Centrica portfolio. So be mindful of that cultural approach.
I also think the heritage of asset management in risk management expertise over several years is important. Some players in the market just don't have that.

What changes to the investment portfolio have you made under the OCIO?
The way to think about this is – it is not as a result of the on-going move to an OCIO – many of the changes were spurred by the gilts crisis. The outcomes of the gilts crisis: improved funding and lower required returns, have resulted in not needing to take as much risk in portfolios.
So as result of the gilts crisis we have a different shaped portfolio. Centrica has an illiquid portfolio, which has gone overweight. We are managing that back down to its original level.

Could you therefore hone in on some specific investment examples.
The illiquid assets in our clients' portfolios are a diversified mix of private equity, private debt, renewables, other long-dated contractual income assets, social housing debt, that kind of stuff.

How has the OCIO fitted in with your ESG objectives?
The introduction of having to do a Task Force on Climate-related Financial Disclosures (TCFD) report has been extremely onerous on all UK pension schemes. And having to put that report together when were a team of seven, was a real challenge. Also, not having any centralised support on best practice made it harder.
Moving over to Schroders, the firm has around 50 dedicated ESG specialists within Schoders Solutions, so we have suddenly been able to plug into central thinking on best practice on TCFD.
On other ESG aspects, it is a similar story, being able to plug into a much bigger support network to help us with our ESG work

Could you expand on your ESG investment approach and net-zero objectives?
Centrica has undertaken an ESG review and is looking to set a net-zero target. The approach is skewed to engagement. Schroders philosophy is similar: a preference for engagement, not exclusions.

How long do you see yourself remaining the CIO within the OCIO?
I am about to turn 50, and my vision is to see this through to retirement. There is a lot of scope for the OCIO trend to develop. There are still quite a few big UK schemes that are likely to go down the OCIO route. That will bring, for me personally, a diversity of client exposure.

As a team we have kept our culture and also integrated into the combined culture. We have benefited from the best of both cultures.

CHETAN GHOSH'S CV

May 2022 – present
Chief investment officer
Schroders Solutions OCIO

September 2009 – May 2022
Chief investment officer
Centrica Pension Scheme

March 2008 – August 2009
Investment consultant
Alexander Forbes

2005 – 2007
Senior investment consultant
Lane Clark & Peacock

Then if we look forward a few years, the applicability is to every other type of institutional investor around the world. Therefore I see plenty for us as a business, and for me personally, to be getting involved OCIO wise.

What do you see as being the macro-economic and geopolitical challenges likely to have an impact on your investment portfolio going forward?
The macro-economic environment is testing every year. The mantra is to build robust portfolios and have sufficient diversification. There is no substitute for that. Sometimes you have to just weather the shorter-term noise by being a longer-term investor.
When it comes to UK corporate pension schemes you clearly have the outcomes from Mansion House. But such is the level of existing de-risking within these schemes that it is not going to have too much of an influence.
For these de-risked schemes, the one thing that could derail you is a glut of defaults on your investment-grade assets that could blow you off course. But without such a glut of defaults, if you are holding these assets to maturity, pensions schemes are likely to stay on track.


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WHAT NEXT FOR THE UK?

As the UK heads to the polls, what could the next five years look like for institutional investors. *Chris Newlands* reports.

After a lot of second guessing by political analysts, prime minister Rishi Sunak surprised even most of his own party by calling for an early July election.

Stood outside 10 Downing Street in the driving rain, with Tony Blair's 1997 general election soundtrack *Things Can Only Get Better* by D:Ream being blared out in the background by protestors, Sunak told the nation to prepare to go to the polls on July 4.

Most had anticipated an Autumn election, allowing the Conservatives time to perhaps hold a pre-election Budget in which chancellor Jeremy Hunt might have been able to offer voters a sweetener in the form of tax cuts or a further drop in national insurance contributions.

But on the same day the election date was announced the Office for National Statistics said public sector net borrowing had increased to £20.5bn in April, the fourth-highest April total since records began, seriously denting Hunt's wiggle room for policy measures such as tax reductions.

And just days before that the International Monetary Fund had warned the Tories against further tax cuts unless they were "credibly growth-enhancing and appropriately offset by high-quality deficit-reducing measures".

In the end Sunak ran out of road and opted for a summer election. But the problem he faces now is that Labour, the UK's main opposition party led by Sir Keir Starmer, are the overwhelming favourites to win, which will not only have major repercussions for the way the country is run but could have significant implications for the way the UK's giant pension industry operates and invests.

According to *The Guardian*, which tracks the latest polling averages based on all major British polling companies, Labour are the clear favourites to succeed at the polls. At the time of writing the figures show 44% of voters would back Labour at the July election, with the Conservatives trailing behind at 23%.

The average betting odds, meanwhile, point to Labour as the 2/17 favourites to secure a majority government – translating as a 90% chance of victory.

A pension fund consultant, who advises on investment decisions but asked to remain anonymous because of the sensitivity of talking about political views, said they have been talking to clients about the possibility of a Labour win for some time. "It has felt inevitable for a while now," they said.

Evidence supports that, with the Conservatives suffering a resounding defeat in the April local elections, losing 474 seats in parliament. Sir Keir's party picked up 186. Labour politician Sadiq Khan, meanwhile, was re-elected as London's mayor, with Labour also snatching a narrow victory in the West Midlands, home to the UK's second-largest city of Birmingham.

Beyond the ballot box

So what are the implications of a Labour government for pension funds, particularly regarding investment allocations? In short, experts say that in terms of valuations water companies and the oil and gas sector look vulnerable from the opposition coming to power, while infrastructure companies, the renewable energy sector and housebuilders are most likely to benefit.

"We only have the bare bones of pledges from the Labour party, and need to see more detailed proposals to fully analyse which sectors could benefit, but there are some broad brush indications that may weigh on or help certain sectors," says Susannah Streeter, head of money and markets at investment platform Hargreaves Lansdown.

The list of winners and losers does not bode well for the likes of the already troubled Thames Water, which has been struggling with rising interest rates on its £18bn of debt and needs a £750m cash injection from its owners.

Indeed, in May its biggest shareholder, the Ontario Municipal Employees Retirement System, wrote off its entire holding in the utility. In accounts filed during the middle of the month, the Canadian pension scheme said it would "make a full write-down of its investment and loan receivable with accrued interest".

This came after another of Thames Water's biggest investors, the Universities Superannuation Scheme, disclosed that it had written down the value of its stake in the UK's largest water company by nearly two-thirds. According to financial accounts published at the end of last year, USS' investment is valued at around £360m, down from almost £1bn a year earlier.

"A tougher stance on water companies that pollute rivers and seas, is likely to weigh further on the utilities sector," Streeter says. "Labour plans to give the regulator more power to increase fines and force firms to strip executives of bonuses. Already the cost of repairs to leaky and inefficient infrastructure is a heavy future burden, and with the risk of fines becoming more severe, it's likely to make the UK water utilities sector even less attractive."

Darius McDermott, managing director at Chelsea Financial Services, agrees: "Water utilities will face challenges under Labour. The party is unlikely to support substantial water bill increases for customers, and we may see the nationalisation of water companies and an eventual wipeout for equity holders."

> **Given the rate at which prime ministers and chancellors seem to come and go, investors may be inclined to avoid second-guessing the result of the next general election.**
>
> Russ Mould, AJ Bell

Labour also intends to set up Great British Energy, a publicly owned clean-power firm, with the running costs to be paid through increasing the windfall tax on oil and gas company profits from the North Sea. This would see the current energy profits levy increasing. However, it is not clear exactly how much would be raised due to the volatility of oil and gas prices.

Streeter says: "A levy specifically on oil and gas in the North Sea is likely to affect smaller companies rather than the larger energy giants, given that they have less capacity to absorb tax changes, and it may lead to fewer contracts being clinched in the supply chain because of this."

Regarding housebuilders, she adds that Labour's pledge to kickstart the building of 1.5 million new homes "by shaking up the planning system" and fast-tracking urban brownfield sites for development would benefit those who have had to deal with weaker demand in an era of high interest rates and slow approvals of new sites. "However, it remains to be seen just how quickly this streamlining of the planning system will take effect," she says.

David Gibson-Moore, founder of investment consultancy Gulf Analytica, who was previously a regional chief executive for Robeco, agrees. He says Labour has pledged to support affordable housing and improving public infrastructure, pointing to Barratt Developments and Taylor Wimpey, two of the UK's largest residential property developers, as well as infrastructure group Balfour Beatty as potential winners from this.

"Following the disastrous Trussonomics mini-Budget from former leader Liz Truss, record inflation and rapidly increasing public debt, Labour is attempting to position itself as a safe pair of hands," he adds.

And what of the impact on the FTSE100 index of Britain's biggest listed companies? Very little should change, investment experts say.

"In terms of the overall impact on the UK equity market from the policy agenda of a Labour government, it is important to understand that the UK stock market is not a simple barometer for the domestic economy," says Jason Hollands, a former head of corporate affairs at F&C Asset Management where he worked closely with pension funds, who is now a managing director at wealth manager Evelyn Partners.

"The UK equity market is highly international in nature, with around three quarters of FTSE100 earnings derived overseas, and so factors like oil prices, exchange rates, global growth and Federal Reserve policy are more significant factors in driving the direction of the British market than UK fiscal policy."

McDermott agrees: "For the FTSE100, where the majority of earnings are made overseas, there will be little impact on share prices.

"The bottom line is the impact of a Labour win will likely be small given the party has gone to great lengths to seduce the City as well as big investors in order to eradicate the memories of former head Jeremy Corbyn's left-wing leadership."

Backing Britain?

One thing that has been a concern under the current Tory government is Hunt's grand plan to get UK pension funds investing in unlisted companies to try and boost Britain's economic growth.

> **A levy specifically on oil and gas in the North Sea is likely to affect smaller companies rather than the larger energy giants.**
>
> Susannah Streeter, Hargreaves Lansdown

In the March Budget the chancellor announced a requirement for pension funds to report how much they have allocated to the UK, suggesting he would examine what further action might be taken if this reporting requirement did not lead to an increase in investments.

Many felt the current government was being a little heavy handed in its approach, with Robin Powell, a campaigner for what he calls positive change in global investing and the author of the blog, The Evidence-Based Investor, previously telling *portfolio institutional* that he believed the government was treating pension funds as a "quick fix for the UK's ailing economic growth".

Even the government's top infrastructure adviser, Sir John Armitt, told attendees at the Trades Union Congress pension conference earlier this year that there is "no reason" a pension fund should be told it must invest in the UK.

However, a Labour victory is unlikely to allay the fears of pension funds, with shadow chancellor Rachel Reeves telling attendees at an event in New York last year that her party aimed to kick-start investment in the UK by speeding up the consolidation of pension funds and allowing capital to flow into smaller private companies through a £50bn future growth fund.

"In the 1990s, pension and insurance funds owned around half the UK equity market, now it is below 10%," Hollands says. "Both of the main parties recognise the problem.

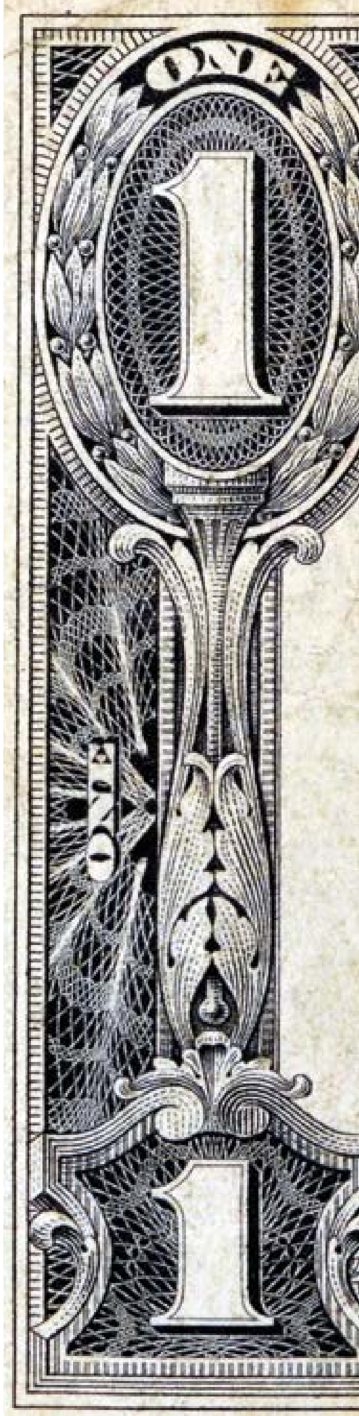
"Rachel Reeves has signalled the need for UK financial institutions to be refocused on supporting UK businesses and infrastructure, so we could see measures that will require schemes to have allocations into the UK market or UK assets in areas like infrastructure of green technology."

This is a theme that Streeter has also witnessed. "Reeves has talked about the importance of encouraging pension funds to invest in high growth UK companies. Again, we are yet to get more detail, and there are concerns within the industry around making sure any reforms work in the best interest of members."

But, whatever happens, the impact of a Labour government on UK pension funds will remain guesswork until the outcome of the July election is decided and Starmer puts more meat on the bones in terms of his policies.

"Given the rate at which prime ministers and chancellors seem to come and go, investors may be inclined to avoid second-guessing the result of the next general election," says Russ Mould, investment director of AJ Bell.

"Increasingly vocal and forceful regulators, such as the Financial Conduct Authority, Ofcom, Ofgem, Ofwat and the Competition and Markets Authority, appear to be responding to public pressure for greater action. And perhaps the hardest part for pension fund investors going forward will be spotting which industry or sectors will come under scrutiny next," he adds.



COST OF CAPITAL: THE PRICE OF MONEY

The days of cheap money are long gone and there are implications and opportunities for investors, finds *Andrew Holt*.

The world's cost of capital has increased significantly in a short period of time. Higher lending rates have dramatically changed the landscape for companies and investors appear more discerning in where they choose to allocate capital.

But it could also be said to be creating market volatility and mis-pricing opportunities. Public versus private markets is one such example, where, particularly in real estate, public assets have seen valuations correct, while arguably, private markets are yet to adjust fully.

Additionally, with higher rates come more attractive yields, which has brought fixed income back to the fore.

So what does it mean for investors? Daniel McCormack, head of research at Macquarie Asset Management, says there are fundamental reasons for the cost of capital situation. "We believe the cost of capital has increased as a result of slowing growth in the supply side of the global economy, rising geopolitical tensions, shifting demographics and productivity growth remaining sluggish," he says.

McCormack's view is the slower growing supply side of the global economy will create more underlying inflationary pressure, requiring higher interest rates to keep inflation in check and in line with central bank targets.

"Risk premiums may also rise in the more volatile economic environment which we expect to prevail for the next 10 to 15 years," he says. And importantly, he adds: "This higher cost of capital is not just a temporary or cyclical development – we believe it is, and will be, a durable and structural feature of the new economic world we are in."

Offering another perspective, James Brooke Turner, investment director at the Nuffield Foundation, says: "Although it may sound odd, the return of a higher – but more normal – cost of capital is a bit like coming out of a Covid lockdown.

"Many of us had lost all sense of time, what time of day and what day of the week it was, so we were happy to emerge back into a structure of 9 to 5, Monday to Friday," Brooke Turner adds. "Similarly for higher rates, many asset owners – but not borrowers – welcome rediscovering a sense of which way is 'up' now price discipline has returned," he says.

This is at least a positive, Brooke Turner says. "Finding that money once again has a cost has meant that capital allocators are more sensitive to where they put it, and a more disciplined investment market is restored," he says.

However, he notes: "Just as the introduction of 'free money' resulted in considerable benefits for asset owners – but notably not for those without assets – the reverse has been true as we have exited this unusual world and that support has deflated a little. The question for me is whether the rate of growth can outstrip this increasing cost of capital."

Nevertheless, Brooke Turner adds: "It seems that there is still some time to go before many people finally capitulate and accept that zero interest rates will not return and Alice will not be stepping through the looking glass again."

Yield backdrop

Sriram Reddy, head of client portfolio management, discretionary at Man Group, points to the issues surrounding yield. "The yield backdrop portends attractive return potential for investors. We are seeing yields from public and private credit that we haven't seen in decades, which is typically a good starting point for what you can expect in terms of total returns in the future."

Reddy's view is that institutional investors are therefore starting to rethink asset allocations. "Looking at those yields as potential replacement for equities, or potentially a bigger portion of overall asset allocation. As we haven't seen these yields for over a decade, at this point some investors are simply looking to lock those in for longer."

Indeed, while average credit spread valuations are not cheap on a historical basis this does tend to mask some of the dispersion seen within markets, which suggests a more fertile picking ground, at least for active managers.

"My sense is that some sectors and issuers are more susceptible to higher interest rates, particularly those that built up significant amounts of debt during the low yield period over the past decade," Reddy adds. "Now that rates are likely to be higher for longer we are already starting to see more pressure emerge in certain sectors and would expect that to continue in the future."

Moving beyond the sector focus, Reddy also notes it is interesting that payment defaults have not picked up aggressively in either the syndicated loan or the high-yield bond market. "But we are seeing more liability management transactions — these are additional tools that companies can use to manage their balance sheet — across those markets, which is allowing more opportunistic credit investments for investors," he says.

Long-term returns

Jill Hirzel, a senior investment specialist at Insight Investment, says many segments of the fixed income market now offer yields comparable to, or even in excess of, the long-term returns of the MSCI World index. "This provides an opportunity to lock in long-term equity-type returns through fixed income markets," she says.

"The largely income-based returns delivered in fixed income markets are typically less volatile and more predictable than equity returns," Hirzel adds. "Bonds are contractual assets which provide payments on specified dates and the income they generate act as a natural buffer against capital losses. This allows investors to achieve their long-term objectives with greater certainty via more reliable, income-driven returns."

Although market yields have moved significantly higher over the past few years, the cost of capital for corporate issuers moves far more, she adds. "This has been even more apparent in the current cycle as many corporate issuers extended their debt maturity profiles during the pandemic to lock in advantageous funding levels for an extended period.

"With the peak in maturities not until 2027, corporates have ample time to make gradual adjustments to their business models to deal with higher rates," she says. The logic is that as central banks gradually ease policy in the years ahead, market rates should also decline, and some corporates may find that they have bypassed the rate shock entirely. "In our view, these factors make the high absolute yields available in credit markets a compelling opportunity," Hirzel says.

Reddy also thinks there is, within the cost of capital scenario, more focus on, and demand for, credit risk sharing (CRS), or significant risk transfers (SRTs), which are part of the private credit universe. "These deals allow us to work with banks to help them relieve some of the burden that comes with the regulatory capital charges in the typical type of lending that they are doing for companies," he says.

"Some types of bank activity are important in maintaining relationships with companies, but not very profitable, so that can be challenging from a capital charge perspective," he adds. "There has been some CRS market activity in the US, and we have seen supply broadening beyond Europe as well as possible opportunities in Canada.

"With spreads at decade highs, this is another potential opportunity for investors."

Private resilience

Jo Waldron, head of client and solutions, private credit at M&G Investments, points to the current situation of investors moving towards private markets. "Private markets have shown significant resilience to various market conditions, thriving in times of prolonged low interest rates and amidst current inflationary pressures."

Waldron argues that over the longer term, private assets have tended to outperform public markets with performance driven by two main components: the 'illiquidity' and 'complexity premiums. Private assets have also maintained more stability than public markets while offering diversification benefits to many

This higher cost of capital is not just a temporary or cyclical development – we believe it is, and will be, a durable and structural feature of the new economic world we are in.

Daniel McCormack, Macquarie Asset Management

> **The question for me is whether the rate of growth can outstrip this increasing cost of capital.**
>
> James Brooke Turner, the Nuffield Foundation

portfolios – what could be said to be a win-win from an investor perspective.

She also makes the point that in an environment of higher capital costs, it is increasingly important to select the right partners who can drive operational value and source attractive assets. "To assess the value of private assets requires the right expertise developed through extensive market experience and deep research capabilities."

Indeed risks are frequently mispriced and overlooked in this market, especially given the lack of transparency compared to publicly traded companies. "This requires unique skills and enough resources to seek opportunities often missed by less experienced investors," she says.

Although the higher cost of capital may drive some dispersion in asset class returns, says Waldron, who believes that concentrating on the intrinsic value of assets and their growth potential, combined with a defensive approach to asset selection, provides investors with many opportunities to lock in mispricing and achieve higher returns.

Interest-rate impact

But for McCormack the higher cost of capital has important implications for many asset classes. "For private markets infrastructure, valuations have been coming off for a while now although certain sectors have been more intensely affected than others," he says.

"Transaction volumes have also moderated as bid-ask spreads have widened in some areas," he adds. McCormack says his modelling work suggests that key to the outlook from here will be what happens with interest rates.

If they fall in the second half of the year – as markets are expecting – valuations, which are sensitive to interest rates, should start to find a floor around the same time, and may even start to edge higher. If interest rates don't fall, valuation multiples could steadily moderate all year.

Although while private market valuations sometimes lag developments in public markets, there are some nuances here worth noting. "For the value of assets held on the book, in some instances asset managers may not have adjusted their interest-rate assumptions down with the market in the period of ultra-low rates, giving them some 'cushion' for when interest rates start to rise," McCormack says. "In this instance, the lag is perfectly normal and rational as markets 'catch-up' to the assumption held by the asset manager."

If we are right about the new macro-economic world we are in – one of higher inflationary pressures and greater cyclical volatility – this is a world very well suited to infrastructure as an asset class, given its inherent hedge against inflation and strong defensive traits.

"Infrastructure could therefore attract fund inflows, something that would work against other forces putting downward pressure on valuations and upward pressure on discount rates," McCormack says.

Risk versus return

In addition, from a longer-term perspective the risk-return proposition of infrastructure may still be under appreciated by investors. "It is defensive, low-beta equity that has delivered returns in line with other asset classes that are empirically more volatile and fundamentally have a higher beta," he adds.

In another area of debate involving the cost of capital, that of private real estate, the downward adjustment of valuations is creating better entry points for new property investments, McCormack says, as cap rates expand from cyclical lows to reflect the higher cost of capital.

"Market dislocation is most evident in the US and European property markets where pricing has adjusted more quickly reflecting the tighter credit standards versus the developed markets in Asia Pacific," he says.

But to complicate matters, unlike previous cycles, jobs growth has remained generally supportive of property fundamentals across most sectors, with rising rents partially offsetting the negative impact of cap-rate expansion on returns across most property types. "The extent to which labour markets hold up will be the key swing factor in maintaining positive near-term demand and rising rents," McCormack says.

On the supply side, higher interest rates and construction costs alongside tighter lending standards are causing new development starts to fall back. "This lower level of new supply may boost rental growth over the medium to longer term, supporting the recovery in property values," McCormack says.

The cost of capital issue therefore means there is much to ponder for investors – but crucially, also opportunities to exploit.

pi ESG CLUB

With protests in parts of Europe and anti-ESG views being shared among lawmakers in the US, the world is facing a growing sustainability backlash. This month's ESG Club looks at the issue to discover if ESG is set to become a niche investment strategy once again.

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CLIMATE CHANGE INVESTOR GROUP SETS OUT PRIVATE DEBT FRAMEWORK

New guidance establishes agenda for private debt investors to deliver on net zero, finds *Andrew Holt*.

The Institutional Investors Group on Climate Change (IIGCC) has introduced new guidance aimed at establishing a framework of action for private debt investors to set and deliver net-zero commitments.

The guidance could well be seen as an indication of how private debt has become an important focus within the net-zero transition.

With this, the IIGCC intends to support any private credit investors who are active in direct lending, venture/growth debt, opportunistic credit, structured credit, fund financing and private placements.

The guidance reflects private market-specific nuances and takes the view that, given the unique characteristics of private debt investments, distinct actions are required to set and deliver decarbonisation goals for the asset class.

The development of the guidance was led by IIGCC with support from Ceres, a sustainability investor network, and incorporates input from a group of participants in the private debt industry, including members of IIGCC's private markets working group.

Some of the innovations introduced by the guidance include a 12-month "grace period" post-deal close. This, according to the guidance, is to "give GPs [general partners] more time to collect the relevant information for reporting against the Net Zero Investment Framework (NZIF) and engage with portfolio companies (PCs) to improve transparency, get portfolio company's expression of intent to progressing along PC criteria and potentially finalising deal terms such as ESG margin ratchets."

Three-way model

It also includes a "three-way engagement model" involving private equity sponsors and the inclusion of requests for climate disclosures in loan documentation.

This model, noted the guidance, is recommended between lenders, PCs, and private equity (PE) sponsors, where applicable, to ultimately encourage consistent sharing of climate/ESG data and to foster discussions across data standardisation across private markets.

Through this model, GPs are encouraged to fulfil their full engagement target by engaging with their PCs on net zero and climate-related concerns as well as their PE sponsors where private debt deals are sponsor backed.

This should enable GPs to broaden the remit of obtaining the relevant information to support the achievement of their net-zero targets, noted the IIGCC.

Misa Andriamihaja, private equity lead at IIGCC, explained the rationale behind the new guidance. "By outlining a consistent industry-wide approach, the new guidance can help raise ambition levels for GPs and LPs active in private credit, as well as underlying portfolio companies," she said.

And Andriamihaja added: "Based on input from a wide variety of industry stakeholders, the guidance's most valuable attribute is its recognition of the specific characteristics of private debt investments. Together with last year's private equity guidance, we look forward to seeing investors create and implement their net-zero plans for private market investments in support of their financial goals."

Niamh Whooley, managing director and head of sustainable investing at Pemberton Asset Management, added: "Private credit investors have a voice and this three-way engagement model recommended by the NZIF helps facilitate active engagement in our asset class."

The guidance largely seeks to promote clarity and action in assessing and disclosing climate-related risks within private debt investments, thereby, hopefully advancing climate change practices in private markets overall.

Industry wide

The guidance forms the private credit component of the NZIF, taking the total number of asset classes covered now to seven.

There is no doubt that private debt is a fast growing asset class with unique challenges, especially when it comes to decarbonisation.

"This guidance balances ambition with practicality, providing bespoke net zero-target types and tailored engagement strategies," said Peter Ellsworth, senior director at Ceres. "The emphasis on communication with all parties in this asset class, including private equity sponsors, will help accelerate climate action by private companies.

"We encourage private credit investors, whether or not they have made a commitment to net zero, to use this guide to inform diligence and evaluate how their assets support the emerging clean energy economy," Ellsworth added.

Last year, global investments in the energy transition reached $1.8trn (£1.4trn), according to Bloomberg New Energy Finance (BNEF). This represented a 17% increase on 2022 – despite the macro-economic, geopolitical and supply-chain challenges that characterised last year.

However, this appears to be nowhere near enough. BNEF estimates that annual global investment needs to reach $4.8trn (£3.7trn) by 2030 and $6.6trn (£5.1trn) by 2040 to put the global economy on track to reach net zero by 2050.

ESG INTERVIEW – FRANCES DEAKIN

“We are an investor with impact, not an impact investor.”

The head of responsible investment at Local Pensions Partnership Investments (LPPI) likens the asset manager to a stick of rock. *Andrew Holt* reports.

Could you give me an insight into your responsible investments?

It is not about investments that are responsible; it is a whole process that is always being a responsible investor. So our responsible investments are our entire portfolio – it is about the process we go through as an asset manager that makes us a responsible investor.

The portfolio is diversified globally. Asset-class wise, there will be examples that people would expect to see from a responsible investor: wind farms and all the good stuff on the green side of the spectrum. But you need all sorts of investments in a portfolio to get the returns needed for our client funds to pay their pension beneficiaries.

So it is about identifying sustainable investments, which come in all sorts of complexions, colours and types.

So you don’t have your portfolio and then a bucket of responsible investments – the responsible investment approach runs throughout your portfolio?

Think of a stick of rock, which is what we are, rather than a packet of sweets.

Therefore how would you describe your philosophy underpinning your responsible investment approach?

It goes back a long way. Probably before LPPI was born, in terms of the conviction of the investors that brought the partnership together. But in terms of the philosophy now, it is very much focused on what we are here to do as an organisation: it is our corporate purpose, that delivery of sustainable return over the long term. That means responsible investment has to be integrated into everything we do.

Could you explain your quite ambitious plan to achieve net zero by 2050?

Net zero is the logical step forward. This is about the long-term sustainability of the market and being a responsible investor. You want to see the whole market rise and we are investing in the whole of the market.

It is around wanting to see that progress towards the Paris Agreement’s targets, to be decarbonising all sectors and all companies to be decarbonising. So looking for your sources of sustainable return from as big a landscape as you can. You cannot do that by picking and choosing. You need to work across the whole market.

The net-zero commitment is ambitious in terms of the work that needs to be done. But we are quite clear that is in partnership with everyone in the market: government, policy setters and regulators. It is the whole market’s responsibility to get to net zero.

We are an asset manager on behalf of public sector pensions, and our job is to get them a long-term sustainable return. But arguably, you won’t be able to do that

if you don't have a net-zero aligned portfolio going forward.

Is it a challenge to keep an eye on the here and now, getting your returns and then having a 2050 net-zero objective?

If you think about the framing of the net-zero commitment, it is not about greening the portfolio; it is about transitioning the portfolio. The most successful transition portfolio will be where you don't need to change anything because the companies you are investing in are changing as you own them.

As long as you keep clarity on what you are here to do, over time more of the market is going to be in that place, but you need to be tracking what you are doing. You need to be setting targets, ambitions and expectations in the market and review that they are meeting them or not. You want the companies you are holding to be the ones which are transitioning.

What are the biggest challenges in addressing responsible investment and net zero from an asset-owner perspective?

There can be practical challenges. For example, how do you evaluate how aligned a company is with net zero? ESG is easier the closer you are to an individual company or asset. The minute you move away from being that detailed, the more complexity you build in. And a net-zero portfolio is complex.

On an individual decision-making level the challenge is data. It is having the information and insight to understand where individual company mandates are and their capacity, and commitment, in moving to net zero.

The whole market has a contribution to make to ensure it is easier for investors to understand where companies are positioned by the reporting information available.

There is a major imbalance on the availability of information in public markets versus for private companies. A great deal of focus is on public equities, but not so much large data sets in private companies. Where there isn't disclosure you have to judge on more generic data that you would prefer not to use.

Do you see that the push back in the US around ESG could come to Europe and the UK?

It is not going to be influential like that in Europe and the UK. In ESG, even though the title itself is problematic, there is an understanding of the sustainability of companies and that the market is evaluated by more than just traditional financial information in the UK.

Investors need to be looking at the drivers of sustainability, which are the E and the S characteristics. Companies being well received by the market need to cover these. That is not going to disappear. So there is no opportunity to row back on this, even if people wanted to.

Do you see a positive trajectory on ESG-related issues among the companies in which you invest, or are some proving problematic?

There are shades of strength to shades that are less strong across the portfolio. But companies increasingly understand the investor interest in ESG. Evidence suggests that it is something they are taking on board. After all, it makes good business sense.

They may not sometimes have the language to talk about how they are doing this or lack the budgets if they are not multi-national companies, but in terms of the journey, more companies are on it, and that is what we are looking for. It is not just about the best getting better, but the whole market moving forward.

You are also heavily focused on engagement and stewardship. How do you approach them?

Ultimately, it is the point of good asset selection. Choosing the right assets in the first place is important. Once you hold the assets, it is being active in the ownership of them. You cannot be active on every asset you own; you are relying on regulators, asset managers and other players to hold companies to account. But the aim is always to get the best out of companies.

When companies don't react in the way you want does divestment become an option?

Divestment is a loaded term. It suggests a cliff-edge outrage. Where actually, the reality is usually more of a continuous process of portfolio managers re-assessing sustainability for everything they hold and consider whether those companies are on the right path. So you consistently see dis-investment for a variety of reasons, as part of asset management.

Divestment can, sometimes, be the right thing to do, but it has to be a full 360 consideration of what is happening, and not just on one issue, in that you are unhappy with one thing. You look at it in the round. It is not done on a whim.

> **It is the whole market's responsibility to get to net zero.**

Does the S part of ESG also feature in your responsible investment approach?

It does. There appears an apparent over balance given to the E – with climate change under the E putting everything in the shade – but the reality is that climate change is the E, the S and the G all at the same time. If you sit down and assess what the S is, it is everything.

The challenge with the S is that it has no sharp edges. It hasn't any natural measures that help box it up in a nice clean way, which you can with climate change. In our assessment of risk return, the S is most definitely in that mix. Companies who treat their employees appropriately within social norms, fulfilling their responsibilities to society and recognising products that are needed, all of that is the S.

What does the investment industry need to improve upon in addressing responsible investment?

We are not doing a bad job. It comes back to it being incredibly challenging to demonstrate what you are doing. It is easier to articulate an approach and describe a process and harder to get into the outcome with something explicitly, unless you are an impact investor, then that is part of the measurement of the outcome. Our chief investment officer uses a phrase: 'We are an investor with impact, not an impact investor.'"

Are asset managers up to speed on responsible investment – as some asset owners have accused asset managers of being disconnected with the RI journey?

We are running pooled funds, so there can be the need for compromise, but I wouldn't say there is misalignment. It is just recognising the logistics of how we invest.

We are very much supported by our clients and listen to what they want.

Has the government done enough to address ESG, or has it dropped the ball on these issues?

Government and policy setters are an important part of the market. The prime minister has different pre-occupations of what UK plc needs to be delivering. But if the government wants to encourage private capital to invest in climate goals it has to do that by incentivising that capital to where it wants, and needs, it to go.

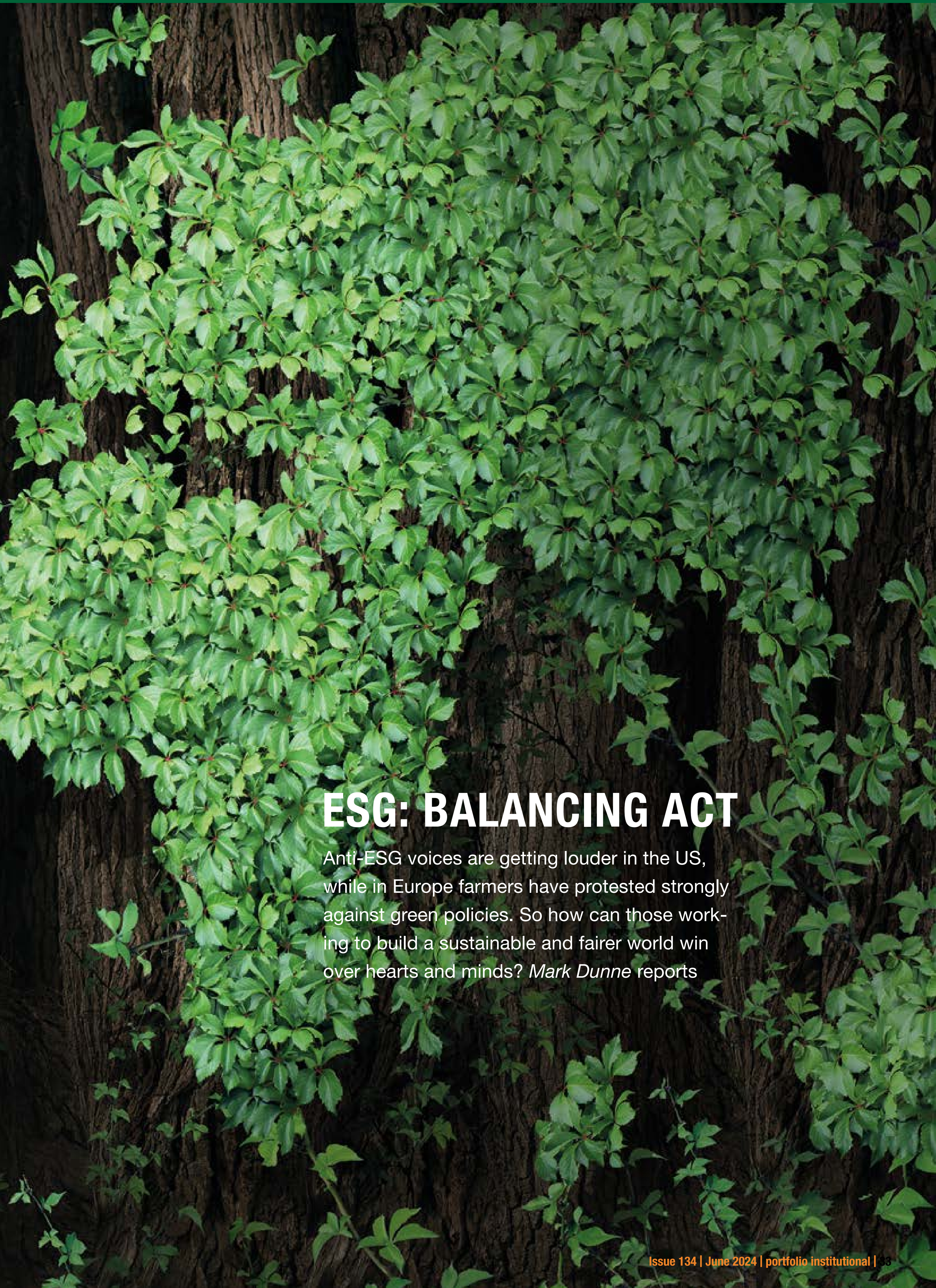
So the government needs to understand the objectives of investors. The influence comes through the incentivisation or de-incentivisation, which comes through the policy, and particularly the fiscal policy route. And investors need policy certainty.

In the eight years that you have been head of LPPI's responsible investment team what has been your biggest achievement?

The biggest achievement is where we are now. We have put a real importance on responsible investment. RI is not what the RI team does, but what everyone in the business does, wherever they sit. That is a great place to be.

What has been the biggest lesson of your career?

My biggest lesson is that my contribution is a perspective, and that I do not have all the right answers. It is the recognition that there are a lot of other people with ideas and perspectives that can teach me a lot.



ESG: BALANCING ACT

Anti-ESG voices are getting louder in the US, while in Europe farmers have protested strongly against green policies. So how can those working to build a sustainable and fairer world win over hearts and minds? *Mark Dunne* reports

Santa Barbara in California turned brown over Easter. Mudslides covered roads and neighbourhoods across the county when five inches of rain fell during the three-day holiday. It was worse a month earlier when people were evacuated from the floods that engulfed their homes after seven inches of rain fell in a single day – breaking an almost 100-year-old record.

But what is most interesting about these storms is that Californians typically live with droughts and wildfires thanks to rising temperatures and prolonged periods of low rainfall. The extremes of dryness and wetness in the state have been blamed on climate change.

With such severe weather events claiming countless lives, California's governor, Gavin Newsom, has introduced laws that require companies with revenues topping $1bn to reveal the financial risks they are exposed to from climate change. As part of this they also have to disclose the volume of their greenhouse gas emissions.

But there's more. It is planned that from 2026 larger companies will have to pay a levy, the size of which will depend on the level of harmful gases they release into the atmosphere.

Yet it appears that Newsom's attempts to reduce the impact of climate change is not a policy that has been embraced by most US states. Indeed, only 24 have set carbon reduction targets. And far from ignoring the issue, some states are vocally opposed to decarbonising their economy.

In Texas, some asset managers are being blacklisted in that pension funds in the state are barred from investing in their funds due to their net-zero policies. This is believed to be the reason why some have quit climate investor bodies such as the Net Zero Asset Managers initiative and Climate Action 100+ in a bid to get back onto the approved list.

But it's not just decarbonising the economy that is being politicised. Investing with a social mandate is also under scrutiny as it could mean a boycott of the firearms industry. Indeed, in Wyoming investors have to disclose whether or not they consider social aspects when making an investment decision.

An insecure move

One of the reasons for such a backlash against laws designed to tackle the causes and impacts of climate change or investing with an ESG tilt is that they are seen in some quarters as a threat to the capitalist system, that is to say they could make everyone poorer and increase energy insecurity.

Oil and gas transformed the world and gave some people a lifestyle that previous generations could never have dreamt of when the first commercial oil well opened almost 200 years ago. So some political figures in the US are openly questioning why they should ditch a reliable and economically successful source of energy for a less efficient system, which may not work if the wind is not blowing hard enough, or if it is too hot for solar panels to work (Yes, really).

The problem is that data has emerged which some believe not only justifies their fears but shows that investing ethically means sacrificing returns. Indeed, most sustainable funds underperformed their conventional peers last year. According to Morningstar, 53% of sustainable funds in the US were in the lower end of the performance spectrum.

And investors have since walked away from sustainable investments. In the opening three months of this year, $8.8bn (£7bn) was pulled from such funds, Morningstar claims.

"When people look at ESG funds versus some other funds, they haven't looked great recently," says a senior investment consultant, who did not wish to be named.

However, this may be due to geopolitical events during the past two years, such as wars in Ukraine and the Middle East sending the price of oil higher and therefore boosting the performance of some conventional funds.

But this misses the point. ESG and sustainability are long-term investment themes and long-term investors, like pension schemes, need to be exposed to such themes. These strategies should not be judged on short-term horizons of, for example, 12 months. Unfortunately, this is not the case.

"People tend to be driven by the last quarter, the last year, the last three years, rather than looking long term," the investment consultant adds. "That is another challenge [with ESG]."

Political instability

Unfortunately, the sustainability debate is set to intensify in some regions as citizens in more than 50 countries head to the polling booths this year.

The US is one such country in the middle of a presidential election, which will not help restore confidence in sustainability after last year's performance. Instead of making ESG less political, decarbonising the economy and reducing inequality could be issues that will be used to separate the Republican and Democrat presidential candidates leading up to November's election. But political backing is crucial to making the world fairer and more sustainable.

"In finance we can't solve all the problems we have with climate and ESG. We need a combination of policy and government stability – so it isn't helpful that half of the globe is going to the polls this year," the consultant says.

It's over here

It appears that the backlash against ESG in the US is spreading to Europe. Indeed, some livestock farmers are pushing back quite hard against the country's sustainable policies. This year they have blocked roads with their tractors and occupied public spaces.

Such protests have been happening since 2019 and were triggered by a proposal in the Dutch parliament to halve the level

of industrial livestock production in the country in a bid to reduce climate pollution.

But the consultant is not seeing much evidence of a backlash against ESG outside of what he is reading in the press. Despite farmers protesting in the Netherlands, any push back is limited. "Across different jurisdictions, ESG is embedded into company reporting. People are looking at it, looking at if there is any element of greenwashing.

"Whether they are doing enough is a different matter, but it is very much on the risk agenda."

An understanding of the importance of these issues is growing, but there is still some way to go until the approaches towards implementing it and measuring impacts are perfected.

"Think about how the awareness of ESG has grown compared to what it was five years ago," the consultant says, but concedes that work is needed here. "There are still problems around greenwashing, around taxonomy and the reporting is quite cumbersome. There are opportunities for improvement going forward."

Inclusive policies

The impact of sustainable policies and investment strategies are not always positive. Transitioning the global economy to renewable sources of energy from extractive forms is a major change. One that could alter the way of life for some and destroy the livelihoods of others.

Indeed, Poland, South Africa and Indonesia are just three of many countries that are economically dependent on coal. The livelihoods of whole communities in these countries depend on local mines. Cutting carbon emissions in these countries is going to be painful.

So making the world a cleaner place that protects the climate and the natural world so that it continues to nourish us with fresh air, clean drinking water, food and medicines needs to consider the impact on communities.

The social aspects of the transition are also an important element of ESG strategies. So providing alternative jobs of quality is a must to make sure that communities are not left behind. But is that message getting through?

"Personally, a just transition doesn't get enough airtime in the UK," the consultant says, although there is a levelling up agenda.

They added that companies are aware of the need for a just transition, especially international pension schemes.

The farming issue in Europe is a prime example of the approach that is needed to bring people on board with accepting more sustainable policies and methods.

Of course, we need nourishment to not only to survive but to flourish, yet with modern animal farming techniques believed to be contributing to climate change we need to find ways of providing the protein we need without it impacting our ecosystem and our nutritional health. Farming provides whole communities with an income and funds local services, the protection of which we need to balance with protecting the ecosystem and the climate.

These issues cannot be left to the corporate world alone to solve. Governments, companies and investors need to work together.

But governments in the developed world are under pressure as their economies are suffering from low productivity. Indeed, this has led them to pulling back on their sustainable targets, so what message does that send to investors? A lack of funding is to blame from governments in Europe that are overseeing low productivity caused by falling birth rates, aging populations and rising diagnosis of chronic illnesses.

They also need to fund the repair and upgrade of their aging infrastructure and repay the huge debt created during the Covid pandemic.

Double whammy

So, can we, as France's president Emmanuel Macron once said, grow the economy and decarbonise at the same time? It's not going to be easy.

"We are on a path to de-carbonisation and de-globalisation," the consultant says. "It is a question of how quickly and painlessly we get there. We have different headwinds with the cost of living and the energy crisis. All of those things are going to feed through at some stage."

It is clear that the message on the long-term benefits of decarbonising the global economy and reducing inequality is not getting through to some, who appear to be living in the moment rather than thinking about the long-term impact of climate change and biodiversity loss.

It could be that the decarbonisation goals for 2050 appear too far away for some, while those targeting 2030 are seen as too ambitious and unachievable. But in a time of growing cashflow negativity among defied benefit pension schemes in Britain, some will be focused on where the money will come from today to pay their pensioners. The risks their portfolios will be exposed to in 10 years' time is not something they are thinking about if they are having to sell units to meet their obligations.

So building a more sustainable world and one that is more equal and safer will mean a seismic change for many. But with the voices of concern at the changes taking place growing louder, there is a big balancing act between making the long-term changes needed and ensuring that communities are protected in the medium term. It is a balance that investors and policymakers have to get right. Otherwise, the backlash could grow to a level that could see ESG become a niche investment strategy once more.

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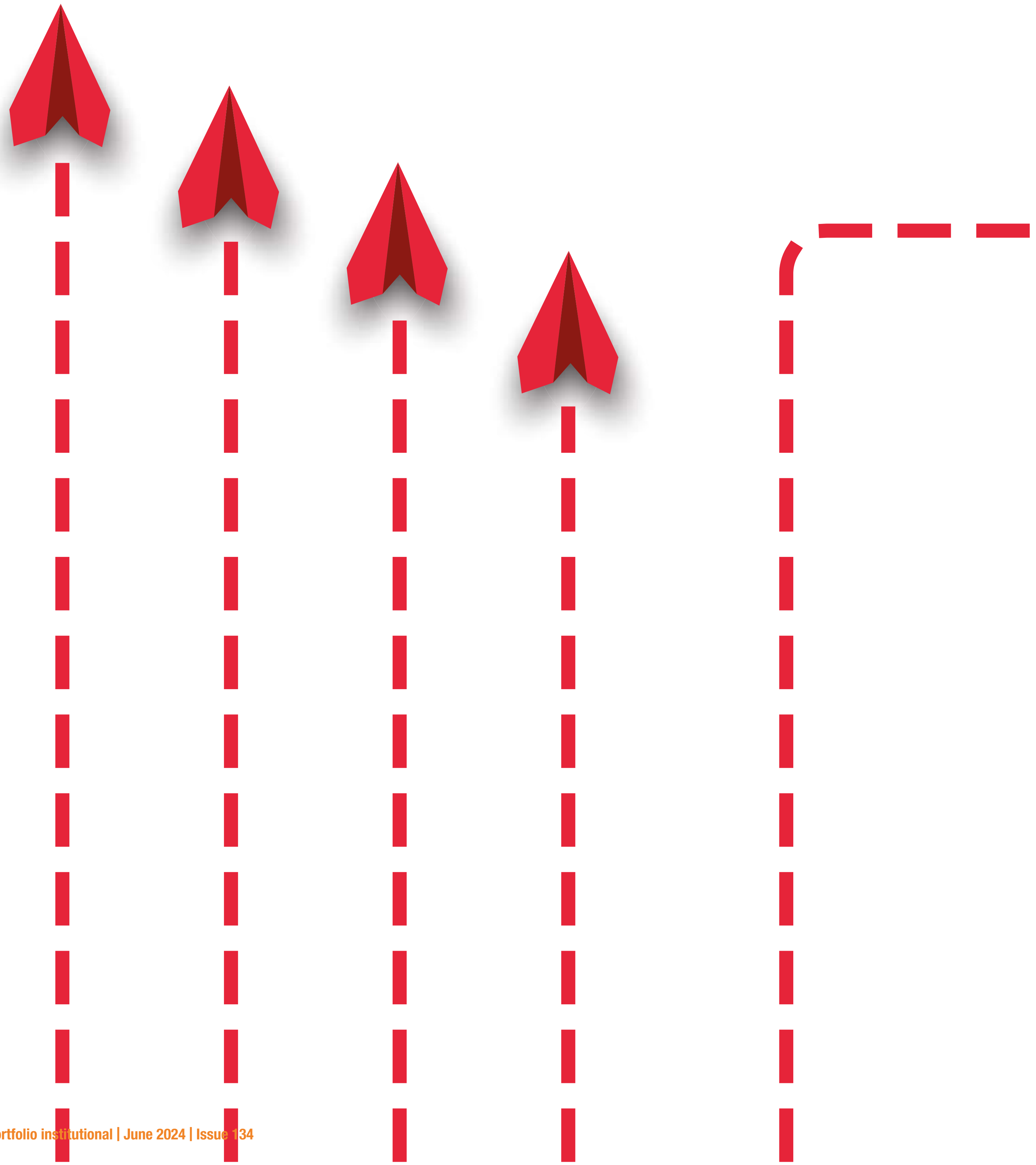
Insurance investors are facing many challenges on many fronts, but appear to be addressing them with aplomb, says *Andrew Holt.*



INSURANCE INVESTORS: ALL CHANGE?

Insurance investors are facing a number of issues that could well mean a change in investment approach with portfolio adjustments. These include higher treasury yields, so called risk premium compression, and the drive to maximize yield, meaning insurance investors may well benefit from reassessing their portfolio balance.

Christian Thompson, director of insurance solutions at M&G, agrees that now, and over the past 18 months, a re-evaluation of insurance portfolios has been brought to the forefront. "Tightening spreads in investment grade credit, but higher yields in government bonds, both of which make up the lion's share of core portfolios, has encouraged insurance companies to re-evaluate their strategic asset allocation under these new market conditions," Thompson says.

"Ensuring the key components of the core portfolio are fit for purpose is, and will continue to be, front and centre of insurers' thoughts," he says.

Thompson also notes that incorporating the additional illiquidity and complexity premia that typically come from investing in alternatives has taken a back seat over the past 18 months. "However the start of 2024 has seen risk-based capital investors like insurers re-prioritise non-core assets with the ambition to add asset diversification and improve portfolio yields – most notably, via senior secured private credit."

Indeed while cash and short-duration fixed income assets are yielding significantly higher levels of income than they have over the past decade, insurers may benefit from strategies that lock in appropriate yields for longer within the risk tolerance of their primary business.

Key considerations include being mindful of liquidity needs, the duration of an insurance company's liabilities, its sources of liquidity and the strategic prioritisation of sources when raising capital – much for insurance investors to ponder.

Liability profile

But it could be said that being mindful of liquidity and duration in the context of an insurers specific liability profile has always been critical to insurance asset management.

On this, Thompson adds: "Looking to add diversifying sources of yield from alternative asset classes into the invested portfolio is increasing. This migration comes with risk, and it is more important than ever for insurance companies to partner with managers who are able deliver everything that is required by highly regulated, conservative investors."

In addition, Thompson says robust internal credit rating methodologies, best in class reporting capabilities, and high-quality underwriting credentials are just a few examples of capabilities that are no longer nice to have, but in fact essential, to ensure the management of alternative assets on behalf of insurers is done at the highest standard.

Moreover, by locking in attractive yields for the long term by using alternatives is good until there is a problem with the underlying asset, Thompson says. "The key therefore is to make sure to go in eyes wide open with good and demonstrable asset selection and structuring credibility and the ability to work through any potential issues should they arise," Thompson adds.

"In short, huge variety of great opportunity for insurers to diversify, improve invested portfolio yields and mitigate solvency capital requirement volatility but, proceed with caution," Thompson says.

Investment strategy

For Chris Howells, head of international insurance solutions at Macquarie Asset Management, looking from an insurance investor perspective and indeed other institutional investors, when considering market-driven investment decisions, it is important to draw a distinction between longer-term strategic investment objectives and shorter-term tactical tilts.

"Tactical asset allocation can, and arguably should, exploit advantageous market conditions through judicious and well-timed tilts to harvest return," he says. "Insurers will want to ensure they are being compensated for any risk they are taking relative to their longer-term liability management objectives in setting their strategic asset allocation."

Indeed, when risk premia are compressed, insurers will have to look harder to achieve additional returns, which could mean investing in unfamiliar territory by asset class, geography, or industry. "A retreat to more familiar markets if they can meet in-force, or new business pricing needs, can be tempting," Howells adds.

Furthermore, Howells says: "If the objective is to build a new or restructure a buy-and-maintain bond portfolio, and sufficient yields to maturity can be achieved without taking on excess credit risk, this could have the additional advantage of being highly capital efficient from a Solvency 2, or other risk-based capital, perspective."

That said, strategic asset allocation is of course not solely driven by return. There will inevitably be competing requirements to invest according to risk appetite and risk capacity in a manner best suited to the nature of the liabilities and the capital adequacy position, while aiming to maximise the returns.

"This is where consideration of other factors play a part in the asset selection and portfolio construction process, including the nature of the liabilities, risk management through diversification of exposures, and portfolio resilience under stressed market conditions," Howells says. "Also important to consider maintaining an appropriate level of liquidity – not too much nor too little."

Ensuring the key components of the core portfolio are fit for purpose is, and will continue to be, front and centre of insurers' thoughts.

Christian Thompson, M&G

Yield enahancement

On insurance investor trends, Ken Griffin, head of insurance solutions at Barings, identifies one where life insurers are continuing to move toward less liquid securities: "Which provide the potential for yield enhancement – while simultaneously de-risking from a credit perspective," he says.

Overall, he notes that life insurers are seeking capital efficiency by allocating toward higher-rated securities, unless spread levels compensate for higher capital and risk. "2023 saw continued movement toward less liquid securities which provide compensation for insurers that can afford the illiquidity risk, allowing for potential yield enhancement while simultaneously de-risking from a credit perspective," Griffin says.

There are four key themes that he believes are shaping asset allocations for life insurers. First is related to the upping in credit quality. Allocations to the highest rated class [A- and higher] have continued higher since 2022 – "When the industry broke a string of five years of declining allocations," Griffin says.

"In particular, allocations increased by 1.7% from the year prior, to 59.1% of total bonds." Interestingly, high-yield allocations have also been declining since hitting a peak in 2020, he says.

The second point is a rise in insurers private bond allocations. Allocations to public bonds have continued their long trending descent by dropping 2% year-over-year. While still the predominant asset class for life insurers, their allocations have fallen by 8% over the past five years to 39.3%.

Meanwhile, private bonds continued their trend higher, increasing 1.5% year-over-year to 15.1%. However, non-privates – also confusingly known as true privates – fell for the first time in five years, slipping 0.7% over the past year.

Structured assets

Third, is a shift toward select structured assets. Given the attractive current yields on offer and capital efficiency, residential mortgages – also known as non-securitised whole loan mortgages – logged the biggest yearly gain of all asset classes, Griffin says. Though a seemingly small 0.4% overall allocation increase, it represents a 42% increase within the class.

That is not all, certain structured asset classes also saw an increase in allocation led by collateralized loan obligations (CLOs), asset-backed securities, and non-agency residential mortgage-backed securities.

Fourth, concerns about the commercial real estate market softened the allocation to commercial mortgage-backed securities, Griffin says. CLOs continued their march higher as the fastest growing asset class over the past five years with an allocation of 4.1%, up from 3.8% last year.

Bank loans, which includes portfolio finance, that is net asset value lending, held steady year-over-year after strong growth in the last few years. Public corporate bonds fell by 1.4%, which was by far the biggest reduction of any class.

Fifth is the increase in lower-rated commercial mortgages. "Commercial mortgage allocations had a slight uptick year-over-year," Griffin says. "Within commercial mortgages, the life industry continued to rapidly reduce exposure to the office sector given concerns about vacancy rates post-Covid."

One also has to look at the wider context to assess movement within insurance investors trends. Pension funds for example have traditionally been some of the more enthusiastic investors in the private credit space, and within private credit, in corporate direct lending. In recent years, solvency in defined benefit schemes has improved, allowing more schemes to look to sell off their pension liabilities to insurance companies.

Insurance context

Insurance companies have historically covered these bulk annuity liabilities with low risk, fixed income investments, but in a higher inflation environment, these pension scheme liabilities were typically inflation-linked, they are now seeking higher levels of return than that afforded by many traditional fixed income investments.

"After the rapid interest rate rises of 2022 and the consequential attraction of a floating rate investment, insurers that took on pension liabilities increasingly turned to corporate direct lending, where higher returns could be locked in for longer as part of an investment in a closed-ended fund," says Howard Sharp, managing director at Alcentra.

Additionally, as defined benefit schemes gave way to defined contribution (DC) schemes, with their generally younger underlying workforces, trustees have looked to offer higher yielding investment opportunities, given the longer period to payout of pensions.

"Insurers who took on liabilities were therefore able to better match these longer-term liabilities with illiquid assets such as direct lending, where the premium to liquid loan markets has traditionally been 200 basis points to 300 basis points," Sharp says.

Underlying portfolios

Insurers are also attracted by four factors, Sharp says. One, the lack of mark-to-market in underlying portfolios versus high-yield bonds and liquid loans, two, a quarterly cash yield, that can be reinvested, three, generally greater levels of control exercised by the lender, leading to higher recoveries in case of default, and four, relatively significant fees at the time of loan issuance, passed entirely on to the investor by the lender.

"General partners have been quick to provide the solvency, carbon and other reporting required by insurers, as well as running sustainability-linked funds under Sustainable Finance Disclosure Regulation," Sharp says.

Overall, in a normalised interest-rate environment, the foregoing elements provide insurers with a viable and increasingly large asset class with which to match their liabilities.

In another development, James Charalambides, partner and head of European private credit at Adams Street Partners, says insurance investors have shown a great deal of interest in private credit.

"We see a lot of appetite from insurance companies in private credit. It has been the case for some time," he says. "There are a few things that make private credit more appealing. The key components of that are: yields are up and private credit is all floating. So when base rates rise, private credit yields rise an equal amount," Charalambides adds.

Equity cushion

The second element is that debt multiples, so the amount of leverage on companies in these private credit transactions, have reduced. "Part of that is the function of the higher interest burden companies can afford less debt from a cash service perspective."

At the same time, there has been some compression in purchase price multiples, but, not that much. "Which means that the equity cushion, that amount of equity versus debt, going into a transaction has increased. And at other times the loan to value (LTV) of the loans is lower," Charalambides says.

"That means that at the same time as yields have gone up in the private credit space, the LTV and the overall risk have gone down," Charalambides adds. "This makes it particularly compelling. And when you compare the returns to other liquid forms of credit, private credit outperforms pretty meaningfully, compared to leverage lends, high-yield bonds and investment-grade bonds."

It does mean that insurance investors are not only just dealing with an investment environment which presents numerous challenges, but more than rising to those challenges.

As yields have gone up in the private credit space, the LTV and the overall risk have gone down.

James Charalambides, Adams Street Partners

THE FINAL COUNTDOWN

$315trn

The global debt pile hit a record high at the end of March after expanding by $1.3trn during the first quarter.

Source: The Institute of International Finance

7.3%

The average weighted return of hedge funds during the first quarter, led by equity strategies at 8.49%.

Source: Citco

9.6%

Prime offices are forecast to generate the highest return of any property asset class annually until 2028 due to a re-pricing. Logistics is close behind on an expected 9.5% a year.

Source: AEW

3.5%

Emerging market debt is expected to offer the highest returns in the asset class during the next seven years.

Source: GMO

31%

Almost a third of pension professionals believe that the Mansion House reforms will not be effective.

Source: Pensions Management Institute

71%

The level of institutional investors who intend to have at least 30% of their assets allocated to private markets by 2028, up from 59% today.

Source: State Street

46%

Pension funds and insurers accounted for almost half of the capital invested in private real estate funds globally in 2023 – a third successive year of institutional investment decline.

Source: INREV

92%

Almost all alternative fund managers use artificial intelligence to manage risk and to meet their regulatory requirements. Transaction and liquidity monitoring are two areas where it is being applied.

Source: Ocorian

50%

Half of UK asset owners either consider natural capital when investing or intend to do so in the next 18 months.

Source: Gresham House/Mallow Street

Quote of the Month

"It is not about greening the portfolio; it is about transitioning the portfolio."

Frances Deakin, head of responsible investment at Local Pensions Partnership Investments