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CLEAR PATH ANALYSIS

INVESTING IN ALTERNATIVES, EUROPE 2019

Determining strategies and accessing alternative assets in a highly competitive market

MARCH 2019

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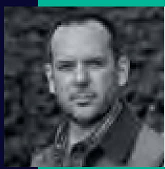

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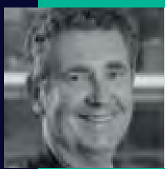

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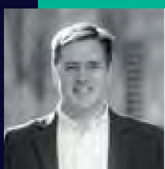

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SECTION 1

ECONOMIC AND MARKET PRESSURES AND OPPORTUNITIES

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Taking notice: Reasons to consider absolute return fixed income

1.1 INTERVIEW

As desire for non-traditional assets continues to grow, where will institutional investors get the best yields given the economic cycle?

Interviewer

Zoi Fletcher, Content Producer, Clear Path Analysis

Interviewee

Toby Buscombe, Head of Matching Plus and Deputy CIO, BAE Systems Pension Funds Investment Management Ltd

SUMMARY

- *Diversification, risk management and generating lower risk income are the focus in today's environment which has a very uncertain outlook for traditional financial risk assets*
- *We think that we can add value to the portfolio through working with partners and taking significant stakes in privately held assets*
- *We are focussed on bounded complexity which requires us to do some work at front and be resourced with market specialists*
- *It is the deal by deal detail that matters, such as long-term stable return generation; reasonable entry prices; low bidding activity and the degree of risk mitigation*

Zoi Fletcher: What is fuelling BAE's desire for non-traditional assets?

Toby Buscombe: In terms of the non-traditional financial risk assets that are beyond equities and bonds, BAE has been quite active for many years.

Through our experience over the years, we've identified a number of attractive areas and factors that we focus on. One of which is looking for diversification and accessing alternative sources of return drivers and income from those factors that sit beneath our equity and bond portfolios.

Also, in today's environment which has a very uncertain outlook for traditional financial risk assets, we have had to consider other areas where we can invest our capital in a more risk managed way.

It is also hard to ignore the very low risk-free rates we currently face which force us and other investors to look for other ways to generate lower risk income from their investment activities.

Zoi: Would you say that pension funds are chasing stable, long term alternatives to government bonds because of the current environment?

Toby: A number of pension funds certainly are but I wouldn't describe ourselves as chasing anything in particular. Our strategy is to focus on those assets that traditional pension funds aren't chasing because we see various of our institutional peers as frankly in a bit of a race to the bottom in terms of the bidding activity that we are seeing from some of them. But we are certainly looking for alternative sources of income that can supplement what we are generating from our more traditional matching book.

We are very focused on diversification and accessing alternative sources of return and income from those that we are getting through our traditional financial risk assets. We are also being spurred on today by the relatively uncertain outlook for traditional financial risk assets.

Generally, we have a philosophical view that there is the ability to add value to the portfolio through investing into privately held assets alongside our more traditional financial risk assets. Where we see enhanced ability to access assets with a meaningful growth profile and/or add value operationally is through working with partners and taking significant stakes in assets where we can then drive value post acquisition. This would contrast to the less controlling stake in various traditional listed companies that we might be invested into.

Zoi: Where are we in the economic and market cycle and where will investors get the best yields?

Toby: If we look at traditional and fairly accepted leading macro economic and financial indicators, we appear to be quite late in the cycle and this is certainly weighing on our investment selection decision making.

This is compounded by a weight of money from other institutional investors into lower risk alternative income generating investments.

I can't say as to where the market could get the best yields but what we are focused on is bounded complexity. This is the idea of focusing on those assets that aren't quite so heavily sought after and that aren't such an easy fit for traditional asset liability matching pension schemes and Solvency II sensitive insurers. For instance, this could be deals that have a compressed transaction time timetable where we would need to roll up our sleeves and move quickly. Or it could be deals that have a degree of construction associated with them so that we would need to work with the partners on putting in place contractual mitigants around that construction risk, which again is an area that many institutional investors would shy away from. There are also assets that have a degree of operational complexity to them, where we would have to work with partners on dealing with an underperforming component of an asset or right sizing a contractual position to ultimately re-sculpt it into a more reliable and stable income over the longer time. But that does require some work upfront.

Assets that involve more complex underwriting are another area that does require us to roll up our sleeves and do some work rather than bid something as if it were a bond substitute (which we won't do). We don't believe in the argument that many so called alternative assets are direct bond substitutes and so we feel that you do have to do the work properly.

We have deliberately resourced ourselves up with our own fixed income, equity and private market specialists so we are quite prepared to do this work on the front end.

These are the areas that we are focused on but importantly this is carried out whilst appropriately managing risk so ensuring that we are not blindly walking up the risk curve. We are putting in place appropriate operational and contractual controls to ensure that we are getting paid for the level of risk we are taking and that it is indeed bounded in nature. We also want to ensure that there is ultimately a path towards a longer term, stabilized profile of income and return generation which is really what we are ultimately looking for from our portfolio.

Zoi: How active is BAE within real estate, infrastructure, impact investing and green investments/renewables, and in which of those areas are you finding the most attractive investments?

Toby: We are active across all of these. These are very broad asset classes and there are numerous types of real estate and infrastructure etc. But fundamentally we have been doing this for long enough to observe that it is really the deal by deal detail that is what matters.

If I look across each of those different headings, I can find ten investments that I hate and ten that I love. There are real estate deals that we have liked that have been sensibly structured and which are generating long term and relatively stable income and which we have been able to access on reasonable entry prices. This is also true for all of the other categories listed. But equally there are numerous assets within each of these categories that are either so aggressively bid by the market today as to make them unattractive for us or, when we look at the detail, they don't offer the degree of contractual and structural risk mitigation that we are looking for within our portfolio.

We have also done things in the wider private debt space and what I would loosely term alternative income generation. For example, enhanced ground rents and private placement loans to locally positioned counterparties, where we are taking a degree of operational exposure to their business in exchange for an enhanced position in their longer-term income generation.

Zoi: How comfortable is BAE with the risks involved in investing in private debt (including high-yield, emerging market debt on the liquid side and private credit on the illiquid side?)

Toby: We are quite comfortable with private debt investing and have done this across the risk spectrum from higher risk, total return focused strategies through our growth book to more contractually protected lower risk investments for our matching plus portfolio which is sitting between our matching and growth assets.

We have our own fixed income team who have quite a successful franchise in writing private debt loans to counterparties that we have gotten to know well. And I suspect that we will continue to find this an attractive space to invest.

Zoi: Do you feel that emerging market debt is going to grow by as much as is being said?

Toby: Historically we haven't been very active within emerging market debt although we may look to consider it selectively through our growth portfolio. But the likelihood of doing it within the lower risk component of our portfolio in the near term is relatively low. This is not because we don't like the emerging market debt story, but because of the challenges around managing currency risk.

Within our growth portfolio we think about the kinds of returns that we are targeting and so we do potentially have some tolerance to absorb currency variation in some of the emerging market currencies. But within our lower risk, income generating component of our portfolio there is less capacity to do this.

Zoi: Thank you for sharing your thoughts on this topic.

1.2 INTERVIEW

Is this a good time to be investing in private debt in Europe and how does it behave through the cycles?

Interviewer

Zoi Fletcher,
Content Producer,
Clear Path Analysis

Interviewee

Nicole Downer,
Managing Partner,
MV Credit

SUMMARY

- *Whilst the retrenching of banks from the leverage loan and private debt markets has had positive implications, the gap has been filled by several unitranche lenders which has led to a tightening of pricing and loosening of terms, but we are seeing moves back in the right direction*
- *Solid underlying fundamentals of the European market, low default rates and relative expensiveness of the USD make European private debt an attractive proposition*
- *Investors with the right manager who has rigorous standards in the types of credits that they select as well as strong monitoring and restructuring capabilities, will find private debt performs incredibly well through the cycles*
- *Having been through multiple cycles provides an understanding of how to choose the right partners, the ability to be more selective, as well as ample experience of restructurings*

Zoi Fletcher: What long term macro changes to fundamentals are we seeing in Europe compared to the more short-term economic cycle?

Nicole Downer: The main macro change that we have seen since the last recession has been quite a secular one in Europe. This has been the move in the leverage loan and private debt markets from a predominantly bank underwritten market to more direct relationships between non-bank lenders and the ultimate borrowers. Before the last recession banks underwrote all parts of the capital structure; from senior debt all the way down to the more subordinated debt tranches. And they did this for all sizes of companies. Over the last few years, changes in regulation have led to banks retrenching from various parts of the market. They retrenched almost completely from the subordinated debt markets which has been positive for subordinated lenders like us.

The other area where we saw a large retrenchment by the banks was from small cap companies, basically companies who have a profit of less than €30 million. This is where we have seen the emergence of a number of direct lenders or unitranche lenders in Europe over the last few years to fill the gap that the banks have left. This long-term change is a positive one for third party lenders such as ourselves: what it means is that the traditional form of supply for loans is contracting, which has positive implications on pricing, structure etc.

In the short-term, however, we have seen a bit of the opposite phenomenon, where the gap that has been created has been more than filled, especially in the small cap market, by a number of unitranche lenders who have been raising significant funds over the past 2-3 years. This is a market that only started in 2011 and so the unitranche lending by non-banks hasn't gone through a credit cycle in Europe. We have seen a number of new entrants who have rushed into this market, creating more supply than demand in the short term. In the medium to long term there are still some very strong fundamentals for this market but in the short term the fundraising seems to have gone faster than the rising demand for the product.

As a result, in the unitranche product space, we have definitely seen a significant tightening of pricing and we have seen a loosening of terms. To be fair, this loosening of terms has occurred across the market, so cov-lite transactions are very much a feature of the European market which is an import from the US and bond documentation more generally. We have also seen some levels of price reduction on the mid, upper mid cap and large cap but this hasn't been as noticeable as in the small-cap space.

This came to a head in Q3 and Q4 of last year and since then we have started to see more positive pricing and pushback on documentation etc. I would say that the market was at its lowest in terms of being borrower friendly and lender unfriendly at the end of last year and we are now seeing it move in the direction we, as lenders, like.

> “IF YOU ARE AN INVESTOR WHO HAS SOME FORESIGHT INTO YOUR CASHFLOWS OR YOU ARE MATCHING YOUR LIABILITIES TO YOUR ASSETS OVER A FIVE TO TEN YEAR PERIOD AND YOU DON’T NEED THE FLEXIBILITY TO PULL OUT OF YOUR INVESTMENTS VERY QUICKLY, THIS ASSET CLASS IS ABSOLUTELY THE RIGHT ONE FOR YOU, BECAUSE THE PREMIUM THAT YOU GET IS ABSOLUTELY WORTH IT”

A small side-bar on loosening of terms: a number of investors express concern about the trend towards cov-lite in the European private debt market. In our view, this risk is one that can be contained by getting sufficiently detailed and regular information from the borrower and having a robust in-house monitoring policy. Other documentation trends which to us are more concerning include EBITDA adjustments, dividend policies and re-cap policies.

These short-term dynamics aren’t really a feature of the macro economy in general because we have seen the demand side growing in this market. But it just hasn’t been growing as much as the short-term supply. So, the features of this market in the short term have been more of a function of the short-term supply and demand issues rather than something that is driven by macro-economic issues.

Zoi: How does Europe compare to other markets in terms of relative value?

Nicole: Europe has a lot to offer investors because, firstly, as an economic block we are a huge part of the global economy. Thus, this asset class provides exposure to some very strong companies, which have a pan-European and even global reach, especially when you are looking at the mid-market and large-cap markets in Europe. It provides an opportunity for investors to get exposure to this economy.

Since the last recession, Europe has been relatively flat to growing in a very moderate way. This means that the concept of a cycle, downturn or slowdown is less likely than in the US, for instance, where there has been some very stellar growth since the last recession. This has certainly been helped by the QE measures that the US took very early on in the last recession, whereas in Europe it took a number of years before it was finally implemented in 2015.

European Private Debt offers good relative value because the underlying fundamentals of the market are strong and default rates continue to be very low in Europe. We see in this specific market that interest cover, i.e. the leverage that is appropriate for the companies that we are investing in, is stronger than in the past. Spreads have been fairly stable, and we see this continuing with growth from the demand side with more M&A activity and a lot of dry powder from equity sponsors, which is where we originate our investments.

Finally, given where the forward curve is for US dollars versus euros, Europe is a very attractive space for US investors. They will get a 2-3% pick up in returns just because they are US dollar investors investing in Euro products. Also, the opposite is true for European investors, where the US is going to look quite expensive for them.

We have also seen demand from Asian investors into the European market, especially those from Japan, for the reasons I have just mentioned. The solid European fundamentals together with the relative expensiveness of the USD makes European investments an attractive proposition.

Zoi: How does private debt behave through the cycles?

Nicole: Private debt in Europe has performed very well through the cycles, providing consistently good returns with low volatility to investors.

One of the concerns that has been expressed by investors about European private debt is that a lot of the fundraising has occurred for the unitranche product which hasn’t actually been through the cycle. This makes it difficult to judge how this part of the market will behave through a cycle. For me, there is a clear differentiation between the unitranche product and the more traditional senior secured loan mainly because we are talking about financing quite different types of companies. The unitranche product caters primarily to smaller and more local companies with quite a lot of exposure to the UK, France and a little to Germany and the rest of Europe, whereas the senior secured product is used to finance larger, pan European companies headquartered throughout Western Europe. So the way that less experienced manager of small-cap funds will react may be different to the space that we are in, which is the more mid- to upper-mid-cap markets. We have been an investor in European private debt through the subordinated as well as the senior tranches since 2000. And we have found that if you are, as a private debt lender, very rigorous in your selection and disciplined in the way that you invest in private debt, you can perform consistently well through the cycles. We have seen this with our own track record.

For us, discipline about the size of the company; the industries we lend to i.e. being rigorous about not lending to more cyclical industries, the private equity partners we do business with and the diversification of our portfolio are key to managing the cycle successfully.

Investors who are exposed to private debt with the right manager who has rigorous standards in the types of credits that they select; whilst also having strong monitoring so that they can react quickly when a company is not performing as well as expected; and finally has strong restructuring capabilities; will find this is an asset class that performs incredibly well through the cycles.

Zoi: Is the illiquidity premium worth paying?

Nicole: You do get an illiquidity premium within this asset class when you compare it to say high yield and I do feel it is a benefit to investors. It is quite hard to measure what the illiquidity premium is, although it is obviously there when you look at the returns of this asset class compared to some others. As important, is that within this asset class, the level of information that the lender receives on the underlying borrower is much stronger than in some more liquid alternatives. This is a contributing factor to the better performance of private debt as the increased information contributes to lowering the underlying risk.

If you are an investor who has some foresight into your cashflows or you are matching your liabilities to your assets over a five to ten year period and you don't need the flexibility to pull out of your investments very quickly, this asset class is absolutely the right one for you, because the premium that you get is absolutely worth it.

Sometimes the perceived liquidity that is inherent in other asset classes isn't there when it matters. The European high yield market is a good example of this, where if everything is going well then, yes, there is liquidity, but if things are going badly in general then there isn't liquidity. So, you end up not getting the premium or the benefit of it when it matters most.

Pension funds, insurance companies and family offices etc. would find that this type of asset class would suit their profile very well.

Zoi: Given that the vast majority of managers in the private debt space have not gone through a cycle yet, how effective will they be on a down cycle and where might the issues be?

Nicole: A lot of the investors who haven't been through a cycle as a direct lender might have been through cycles under different guises, some of them as CLO managers, which is quite a different proposition. And some have operated in different jurisdictions such as the US which works very differently than Europe.

As a result, a downturn could be challenging for a number of the unitranche lenders. Partly this will come from the concentration of their portfolios in two or so geographies, but where we are going to see the difference between good and bad managers with limited cycle experience is in how disciplined they have been in terms of the credits they have selected. When you look at some of the deals that have been funded, the discipline that we feel is so important is less apparent – for instance lending to companies in the retail space or companies with high capex. Some lenders argue that their control, through covenants or being the only lender, makes up for weaker credits. We don't share this view.

The benefit of investing with managers such as ourselves who have been through multiple cycles in the European market, is that we are more defensive and conservative because we know how credits and cycles work, and we have learned from past mistakes. When you are looking at private debt, it isn't about investing with the cleverest manager. It is about investing with the manager who is the most experienced. In determining how to minimise risk, it is obvious, when considering which industry to invest with, that retail is going to be more cyclical than healthcare, but you then have to understand how, within those industries, you choose the right partners. This means a company that is a leader or has a strong position within its field, with a strong management team, a responsible and experienced private equity owner, robust ESG policies within the company, to ensure that you invest with companies with sustainable products, with good corporate practices and positive (or at the very least not negative) influences on the environment.

Another benefit of experienced lenders such as ourselves is we have strong and deep relationships within the market. This means that we get to see many more transactions which allows us to be selective. One of the challenges for newer managers is that they don't have as strong a network or reputation, which means they don't have the luxury of being selective. For instance, in our senior funds, we have originated over 700 loans in the last 3 years but have only made around 90 investments. We have the ability to be selective; saying no a lot more than we say yes. This is key to seeing who the winners and losers will be.

Finally, having been through multiple cycles provides ample experience in how to deal with restructurings. These processes are complex, vary by jurisdiction and are most successful when all stakeholders are consensual and deal with issues early.

Of course, the challenge for investors in unitranche funds will be that they will have to wait to see what happens, because a number of European Private Debt managers just don't have sufficient relevant track records.

Zoi: Thank you for sharing your thoughts on this topic.

1.3 WHITEPAPER

Taking notice: Reasons to consider absolute return fixed income

Paul Skinner,
Investment Director,
Fixed Income,
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Chris Perret,
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Director, Alternatives,
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Lori Whiting,
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The sell-off of risk assets late last year underlined that market conditions are changing. After years of strong returns buoyed by the support of central banks, almost all traditional asset classes delivered negative returns in 2018. Our research suggests that the global cycle will continue to transition in 2019.

In this environment, we think investors need to ask some pivotal questions about their fixed income allocations:

- Where will my returns come from?
- How diversified are my bond holdings?
- Do I have too much interest-rate risk?
- Do I have too much beta exposure to credit?
- How will my portfolio hold up in a risk-asset sell-off?

In our view, alpha-focused absolute return fixed income strategies could help investors find constructive answers to these questions — and orient portfolios for this late stage of the expansionary cycle. We think there are several key reasons to consider (or reconsider) such strategies now.

1. Higher volatility seems likely to persist

There appears to be a growing consensus that the long era of low volatility has ended. Why? We think it relates to uncertainty. The list of worries on investors' minds is long: inflation could overshoot, forcing central banks to tighten policy more aggressively; the business cycle is in its late stages; trade disputes could accelerate an economic slowdown; and geopolitics remains turbulent.

Higher volatility is no friend of beta, partly because it generally makes an asset less efficient from a capital-allocation standpoint (all else being equal, higher volatility will lower an asset's Sharpe ratio, a measure of risk-adjusted return).

But volatility can be helpful for flexible alpha-focused strategies such as absolute return fixed income approaches, given the potential opportunities that arise as asset prices deviate from perceived fair value. By taking long or short positions, absolute return strategies may be able to take advantage of mispricing in either direction — i.e., when an asset's price is below fair value or when it's above it.

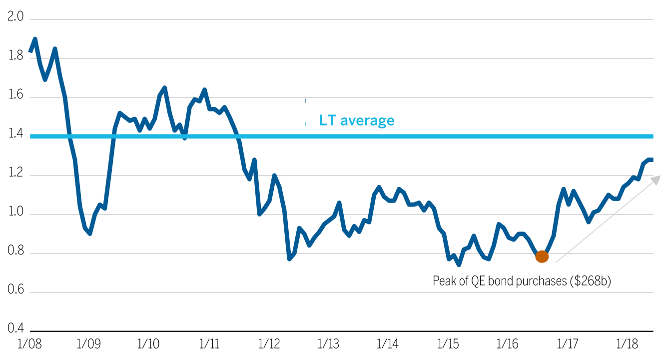
2. Differentiation is rising

As policy becomes less accommodative and the conversation shifts towards country-specific topics — such as inflation, consumer confidence and financial conditions — assets are starting to behave in a less synchronised fashion.

This can be seen in developed sovereign bond markets, where performance has diverged increasingly since central-bank bond buying peaked (see chart).

We believe differentiation is on the rise. In our view, absolute return fixed income strategies are well suited for such an environment, given their focus on alpha (versus beta) and flexible approaches (e.g., the ability to take short positions).

Sovereign bond variability is on the rise
Standard deviation of 5-year bond[1] yields in the post-crisis QE era



[1]The 5-year government bond yields used in this analysis include the following: Australia, Canada, Germany, Japan, UK, and US. ***PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS****. For illustrative purposes only. Not representative of an actual account or investment. Sources: Bloomberg, Wellington Management. The date range is from 31 January 2008 to 30 June 2018.*

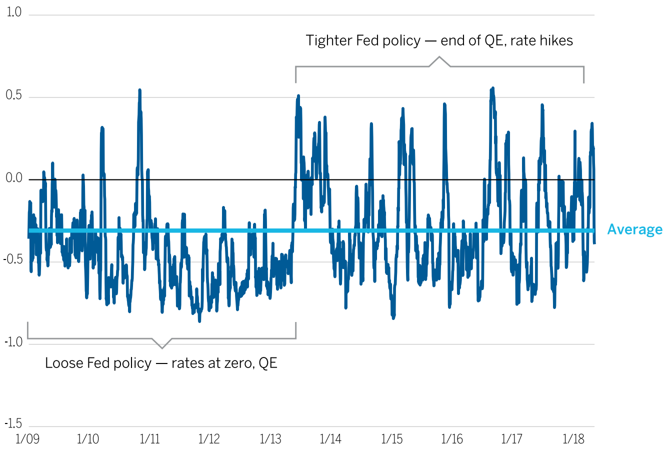
3. Correlation spikes have become more frequent

Most of the time, equity and bond markets move in opposite directions. Yet late last year, stocks followed bonds down after US-inflation concerns triggered a sell-off in debt markets.

Since the US Federal Reserve signaled the end of its QE programme in 2018, the frequency of these positive-correlation spikes has increased (see chart). It is notable that synchronised movements of equities and bonds became more frequent in the last US rate-hiking cycle. Short-term reversals of the habitual relationship between stocks and bonds may become more common in the current late-cycle phase, too.

Absolute return fixed income strategies provide a potential remedy. Given their goal of achieving low correlations to market betas, absolute return approaches offer a way to embed portfolio-level diversification.

Correlation "spikes" have increased in frequency and magnitude
20-day correlation between US equities and bonds[2]



[2] *US equity returns are measured using the S&P 500 Index. US bond returns are measured using the Bloomberg Barclays US Aggregate Index.* ***PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS****. For illustrative purposes only. Not representative of an actual account or investment. Sources: Bloomberg, Wellington Management. The date range is from 02 January 2009 to 31 May 2018.*

Implementation

While the theoretical case for absolute return fixed income may stack up for an investor, it's crucial to recognise that this a highly heterogeneous field, with managers exhibiting widely differing styles and risk/return profiles. For example, if an investor's primary objective is to diversify a portfolio in a rising-rate environment, identifying managers with a demonstrated skill in duration management would be an important consideration.

Other key differentiators between absolute return approaches include risk management, or more specifically downside mitigation, and portfolio liquidity. We have observed considerable differences in the attention given to these two important areas, which we highlight as a potential way of filtering the strategies that warrant further due diligence.

Finally, it is important to try to identify a strategy with true absolute return characteristics and no structural bias toward any of the major asset classes; i.e., low correlation with fixed income, equity and alternative asset classes. While past performance is no guarantee for the future, we advocate looking for strategies with a solid track record of generating positive performance regardless of whether equity, credit, government bond, or currency markets were positive or negative.

With these caveats, we believe the market environment has changed in a way that favours absolute return approaches. We would encourage investors to consider the benefits these alternative approaches may be able to bring to a broader portfolio.

SECTION 2

ACCESS TO ALTERNATIVE ASSETS

2.1 WHITEPAPER

With the increased competition, how will institutional investors exploit their competitive edge to access non-traditional investments?

2.2 ROUNDTABLE

Are long-term illiquid investments the way forward; what other strategies are available to investors?

2.3 WHITEPAPER

Channelling technology to provide access – alternative finance in the spotlight

2.1 WHITEPAPER

With the increased competition, how will institutional investors exploit their competitive edge to access non-traditional investments?

Duncan Hale,
Fund Manager,
Secure Income Funds,
Willis Towers Watson

At the basis of this whitepaper lies a simple, inherent question; what actually is the competitive edge of institutional investors? The typical answer to this question is time. That is, given the long-term nature of the objectives that institutional investors are (usually) looking to deliver against, the institutional investor can afford to take longer-term views and access longer-term risk premia (in particular, illiquidity risk) than other investors in market. By our estimation, in some areas this risk premia can be worth up to 2-3% p.a. Enjoying this much additional income for investing into long-term assets that are more aligned to the timeframe of your objectives (while also allowing for other benefits, such as being more aligned to a sustainability mind-set) is a large advantage for the institutional investor.

At the same time, it is generally accepted that institutional investors have a competitive disadvantage when it comes to execution. Building internal capability is very difficult for a vast majority of institutional investors (by number) having the scale to build a team and program of a size to justify an execution capability is not practical. Further, often the more problematic aspect is placing the transactional requirements of execution (governance around decision making, team skill set and remuneration and execution risk) within an institutional investing organisational framework that generally is not set up to accommodate these demands.

Based on my experience, I do not believe that a lack of execution capability in alternative investments should concern most institutional investors. This is because a focused execution capability reduces investment flexibility, and ***investment flexibility is the key competitive edge that institutional investors enjoy***. The nature of alternative investments means that best-practice execution capability is by definition narrow. As an example; the skills required to source and manage solar renewable assets are very different to those required to manage a portfolio of direct lending assets. As an institutional investor your sole focus is on accessing assets with return streams that assist in achieving your objectives. Creating structures that focus on delivering this singular objective is crucial to delivering on these goals. The flexibility to do this through accessing the best assets (through the best execution partners) from right across the alternative asset spectrum maximises the chances of success.

And the ability to have a long-term mind-set and be flexible in accessing assets is even more important in times of increased competition for assets. Significant capital has flown into alternative assets over recent periods. IJ Investor recently reported that fund-raising in infrastructure in 2018 topped the $100bn mark; this from an asset class that didn't really exist outside of Australia 15 years ago. Similar stories can be weaved through the broader asset classes of real estate and illiquid credit. In many cases this has led to higher prices, slower deployment and/or strategy drift (Did we learn anything from 2005-2008?)[1]. In this environment, having the flexibility and timeframe to pick and choose your spots and finding those pockets where capital is sparse and best practice execution can add significant value, are critically important.

So how do institutional investors make the best use of this flexibility? There are three elements that are needed to optimise this competitive edge:

1. Decide what you want to achieve from your investments into alternative assets
2. Identify interesting areas that meet the strategic requirements
3. Access best practice execution

Decide what you want to achieve from your investments into alternative assets

One of the most interesting aspects of working in alternative assets is the breadth of the asset classes. A prime building let on a long-term lease in Frankfurt and a new-build hotel in a holiday resort in South

[1] *https://ijglobal.com/articles/138310/infra-fundraising-oops-we-did-it-again*

East Asia are both real estate assets, but their risk profiles and what they offer to institutional investors' portfolios are substantially different. The same is true across infrastructure and illiquid credit, both within and across the various asset classes that constitute alternative assets.

This breadth makes alternative assets an incredibly fertile ground for institutional investors, no matter what their objectives (whether paying benefits for defined benefit schemes, growing pension pots for defined contribution superannuation schemes or managing risk and return in an endowment capacity) there are elements of the alternative asset space which can help in fulfilling their requirements. However, the flip-side to this is that there is a universe of assets that don't necessarily add value versus what you are trying to achieve.

Institutional investors need laser focus. Understanding what alternative assets can help them achieve is critical to success and maximising value. This is particularly important given the illiquid nature of alternative assets.

While I would argue that the longer-term nature of institutional investor's objectives means that most can take on more illiquidity premia risk, there is a finite amount of illiquidity that any investor can take. Given this, it is doubly important to focus your alternative investments on those areas which provide the most benefit for meeting your strategic objectives.

A good example of this is the recent trend by many European Defined Benefit investors to focus on alternative assets that provide long-term, inflation-linked cashflows; these are often referred to as Secure Income Assets (or SIAs). As many European investors look to de-risk and focus more on how they will deliver the long-term inflation-linked cashflows required to meet their benefit promises, using alternative assets to provide a strong element of these requirements is growing rapidly in popularity.

Identify interesting areas that meet the strategic requirements

Are having a laser focus and identifying flexibility as a competitive edge inconsistent? No, they are indeed consistent. Laser focus is all around identifying the types of assets that are needed to meet your objective. In of itself it does not provide particular insight or competitive advantage, but it does allow an institutional investor a framework against which to determine the value of any type of investment. However, within this framework, giving yourself the maximum available opportunity set to meet these objectives is critically important.

This approach means moving away from allocating to traditional asset class boundaries such as real estate and infrastructure (which as described above may be unhelpful) and leads to a more holistic approach to allocating capital. The focus is on finding assets that deliver specific characteristics that an investor is looking to deliver. In the case of SIAs this focus is on finding assets that deliver the cashflow profile that meets the objectives; that the assets that deliver these characteristics (such as long lease property, ground rents, social infrastructure and renewables) usually sit within the broad definition of real estate and infrastructure is not a driver of the investment decision.

This approach is helpful at all times but is particularly helpful during periods of high competition. Defining investment objectives based on characteristics, rather than allocating capital within narrowly defined asset classes or strategy buckets, allows the institutional investor to pick and choose spots across a range of areas that help deliver a specific objective. This means that they have the ability to avoid those areas which are most competitive. Probably the best example of this within the SIA universe is senior infrastructure debt; due to significant investment in this area returns have been compressed significantly. A rigid asset class driven approach where an allocation to infrastructure debt had been agreed would lead to an investment in this area. However value can be generated by allocating to other parts of the SIA universe which offer similar cashflow characteristics but with better returns. This is not trying to disparage infrastructure debt; in a few years' time other parts of the SIA universe may be over-priced and it may be infrastructure debt that looks attractive. The key point is that an approach that allows you to take those relative value decisions adds value, and the institutional investor is well placed to implement such an approach.

Where this approach adds most value is where an institutional investor is willing to innovate. Through a combination of research, insight, market contacts and a fair amount of luck, it is possible to find new areas of investment that are less exploited than those areas that have been tried and tested. And following detailed due diligence it is possible to invest in these areas with confidence in the risk profile together with the potential for greater returns and the ability to deploy capital quickly. Even in today's market where there is significant capital for alternative investments, there is the potential to find parts of the market where capital is scarce. Another example in the SIA space is investing in supported social housing for vulnerable adults in the UK. For various reasons this has traditionally not been an area which has accessed a significant amount of institutional investment. This means that those willing to invest in it today can generate an attractive risk-adjusted return while also generating significant community benefits by investing in this chronically under-invested but socially critical part of the market.

This ability to identify the new and innovative idea is difficult; it takes skill and judgement as well as an ability to think and (then importantly) act in a contrarian way. Governance needs to be sympathetic to the approach. However institutional investors have a real competitive advantage when it comes to accessing these types of ideas.

Access best practice execution

The way that the most successful institutional investors access execution has evolved over recent times. Rather than simply 'consuming' the offerings proposed by alternative investment managers, institutional investors are now engaging in areas where they identify skill to shape the products offered. This allows for institutional investors to help best practice execution partners to better understand what institutional investors require Institutional investors benefit by improving structures, terms and fees in the vehicles in which they invest, while best-in-class execution benefits by de-risking their fund-raising.

Again, this approach increases flexibility, particularly when institutional investors act in concert to increase the amount of capital and influence they are able to exert. In this way, institutional investors have the ability to access best-in-class execution across the broadest possible range of investment opportunities. The key is a) being able to identify the best-in-class execution and then b) convince them that the institutional investor(s) can deliver on what they have promised.

Willis Towers Watson and our clients have been investing in alternative assets in this way for the best part of a decade and have a long track record of working with managers to create new and innovative ways of accessing parts of the market previously untouched by institutional investors. We have found this track record is a virtuous circle. By working with managers to invest capital into new areas that deliver stronger returns, additional capital is able to be invested into new ideas increasing the attractiveness to best-in-class execution.

The ability for institutional investors to make the best use of the flexibility they enjoy will determine how successful they are with respect to investing in alternative assets. By focusing on what they are trying to achieve, identifying the best assets and strategies that help to meet these objectives and then working with the market to access the best-in-class execution capabilities that exist, institutional investors can make best use of the rich blend of assets that are available from alternative assets, while at the same time navigating away from those areas that demonstrate the pitfalls of excessive competition.

2.2 ROUNDTABLE DEBATE

Are long-term illiquid investments the way forward; what other strategies are available to investors?

Moderator

Zoi Fletcher,
Content Producer,
Clear Path Analysis

Panellists

Mikael Huldt,
Head of Alternative Investments, AFA Forsakring AB

Christian Boehm,
CEO, APK Pensionskasse

POINTS OF DISCUSSION

- *Alternative strategies should focus on what is the real source of the illiquidity premium and whether it is an additional risk or not*
- *There has been huge innovation in alternative strategies which can be split between absolute return and relative return strategies*
- *Hedge fund strategies are being challenged in the current environment because they are not adding low correlation as they were supposed to*
- *Long-term infrastructure lending can be problematic, because of the unknown inherent risks, and they may look less attractive on an absolute return basis*

Zoi Fletcher: Would you say that current alternative strategies focus on using the additional returns generated through illiquid assets to be able to provide a reasonably certain set of cash flows?

Mikael Huldt: Generally speaking, illiquidity premia is one of the places that long-term investors can go to extract value on a relative basis compared to liquid alternatives. This is true for private equity compared to listed equity or private debt compared to traded bonds etc.

The question is whether they can provide a reasonable set of cash flows and this depends on what your definition of reasonably certain, but in today's environment, with shorter holding periods and shorter durations, there is very high liquidity. And it goes back to liquidity being pushed into the system by central banks through quantitative easing. One should expect cashflows to come back, but one should expect that in the future, durations and holding periods will be extended and it will be more normalized. What you see in today's environment should not be expected to be the form in the future. Also, the ability to seek illiquidity premiums is not for everyone and investors should closely monitor and stress test their total exposure to illiquid investments. Any gains generated through illiquidity premiums are easily eroded and more if an investor is forced to sell illiquid positions and the wrong time.

Christian Boehm: When investing in markets that are not publicly traded, the question is what is the real source of illiquidity premium that I would want to have. It could be that the illiquidity premium is a source of risk that we have not estimated in the process of identifying such assets. This is because there are several reasons why certain assets are not traded on a daily basis and why some are illiquid. Some of these reasons are very obvious, for instance, real estate. But in the other areas there is a question around what is the real source of the premium, is it an additional risk or not? Therefore it depends on which category of illiquid assets you are considering.

> ONE NEEDS TO LOOK AT THE UNDERLYING FUNDAMENTALS OF THE INVESTMENT STRATEGIES AND SEE WHETHER YOU ARE TRULY GETTING ILLIQUIDITY PREMIUMS AND WHAT TYPE OF RISK YOU ARE TAKING

Interest rates are extremely low and we have all seen the risks of rising rates if the national banks decide that we have reached some kind of bottom line as interest rates are pressed down. Private markets have not been less affected.

Yes, it is an additional source of return especially for those investors who can plan their cashflows precisely. As a pension fund, we have a very long-term obligations on our books, so we can harbour these premiums. On the other hand, in terms of the difference between liquid and illiquid, the premium is not always due to illiquidity because there can be additional risks.

Mikael: I agree. And it is one of the areas where one has to be very careful. One needs to look at the underlying fundamentals of the investment strategies and see whether you are truly getting illiquidity premiums and what type of risk you are taking. Some things are structured and packaged in a way to become illiquid whereas the underlying risks might be something completely different when you look at the performance drivers.

Zoi: What new alternative strategies, structures and new avenues for investment will be brought on by the challenges around deployment of capital?

Christian: It is very important for us to cover the full spectrum if possible because markets have different cycles. We look at all the alternative investment cases that are possible. Due to regulations there is a limit to what we can do.

The public markets have high volatility and we have made it a primary goal to decrease volatility in our equity portfolio. We see developments driven by cashflows and the fact that some investors tend to have more behavioural biases. So a lot of money is going in and out of publicly trade markets in a short period of time. This is why, in private equity for instance, we see it is a real investment in companies and not only a trading activity.

For us, it is always a question of looking at which alternatives to invest in, in relation to what is the non-alternative pocket i.e. public equity versus private equity. If we look at the valuations in these markets and see a valuation gap, it makes it more reasonable for us to invest in an illiquid or alternative market. The same is true for classical bond investments in relation to private debt and senior secured loans.

On the other hand, real estate is a very special case because we have this low interest rate environment at the moment so that in the classical real estate markets we have seen very high valuations. This means that for us within alternative investments we have primarily looked at how the valuations compare against classical investments. If we have a high conviction that the valuations are fair within the alternative investment space, we do have a preference for them. And this is something that we always try to keep in mind when thinking about what the main reason to invest into these asset classes is, as they are a substitute for what you would find within a traditional portfolio.

It is always important to look at alternatives in relation to the classical assets. Then you have to see which combination gives the best risk return profile within the overall portfolio.

Zoi: Could you describe what you mean by the valuation gap?

Christian: Yes, and there are different valuation methods for private equity and public equity markets. However, from a historical perspective you can look to see whether private equity for instance is now at a historical high or low and the same would be true for different valuation models in public equity markets in terms of where we are at the moment.

We always see valuation developments in both public and private markets. For instance, last year, the valuation of publicly traded markets had high volatility and illiquid alternative private equity was relatively stable.

For instance, when markets are going down, as we saw in December, the public markets had an immediate reaction but within the private equity market there was no real change. In a different economic environment, it would be interesting to see whether these assets reacted and if so, how?

Also, if you look at interest rate driven investments such as bonds in relation to private debt, the main question is whether the spread is fairly priced in or not. This means that we look for items like investment grade bonds in relation to private debt markets. If you can identify the underlying risks, then you have a better risk return profile within private markets, which is what we would prefer. If there is overdemand in those markets, which could happen, we would avoid it and stay in the other market.

Mikael: There has been huge innovation in new strategies. And it has come down to whether you look at these strategies on an absolute return or relative return basis.

There are a number of strategies being launched today that are offered as being attractive on a relative basis.

launched both in private equity, real estate and infrastructure etc. And this does address the issue of staying invested for longer.

Also, an issue that is less talked about is that with the capital that is flowing into alternatives, it means that competition will increase, which should lower future expected returns. And with lower returns being expected, these returns will be able to withstand a lower degree of transaction costs. The historical model has been fundraisings every fourth or fifth year. But selling the underlying assets and raising these funds means that there are quite a lot of transaction costs involved that one needs to bear in mind. If you could take these out of the equation, then it does address a vital point in terms of maintaining attractive absolute returns for these asset classes.

Zoi: Are more institutional investors adopting ESG, RI or impact strategies and how easy are they to align with alternative investments?

Christian: In general, yes. It is obvious that ESG is much more on the table than it has been in the past. Within alternative assets it is a little bit more complicated because you don't have the data that is relevant to make ESG valuations. It does depend on your strategy which is something that is easier in private equity. But in hedge fund structures it can be very complicated. And some say that hedge fund strategies are completely outside of the spectrum if you want to invest with an ESG aspect.

In certain areas there are big differences between what ESG and impact mean as there are many definitions around these terms. But on a very general basis, yes there are some areas where if you want to invest in impact strategies then you have to do so through alternatives.

> "Alternatives will definitely play a role in the expansion of dedicated impact strategies and will see an increase"

You see this particularly with alternative credit because you can compare the returns that you can get in publicly traded or government bonds. Also, with the current interest rates, on a relative basis, it is not too hard to offer interesting strategies that promote higher returns. The main question here is whether these strategies will be around once interest rates normalize.

Many people are looking for new strategies and structures that sustain investments. This is because the holding periods and durations have been shortened as generally there is a high churn of capital with a short payback. This has meant that is has become very hard to stay invested and maintain exposures to alternatives.

On staying deployed, there has been quite a bit of innovation in terms of new structures. Evergreen structures, longer-term funds are being

For instance, with new energy or energy transitions, a lot of investments are offered around private equity or debt and infrastructure. So if want to go down the impact route, then you would look more and more towards private equity investments.

In real estate, if you have a long-term investment perspective you have to bear in mind what will be important in the future; that the buildings in which you are invested won't be damaged by natural disasters because there is a risk of flooding etc. Also, the quality of buildings is something that is now important to the same degree as the region in which you invest, which has been an important focus for investors. You want to be invested for a longer period of time and therefore the question is whether the building is sustainable. We look more than ever before at certificates, which show how the building is heated, cooled etc. These are issues that are much more on the table than ever before.

Mikael: Yes, in Europe and particularly in northern Europe, it is definitely an area of focus, although less so in other areas. But it is coming along. The issue is that people are putting varying definitions on the term ESG and whether it is the E, S or G that should be emphasized. This means that there are very different methods being used to address this issue within their investments.

Alternatives will definitely play a role in the expansion of dedicated impact strategies and will see an increase.

As with everything new, there is an issue with "green washing" in the sense that some strategies are being labelled something that they perhaps aren't. These types of issues will need to be addressed.

Christian: The topic is evolving, and we can see issues coming more to the forefront, such as the green washing risk and what ESG means more generally and its impact.

Questions are now being asked around issues such as what responsibilities the investor has to take on compared with those of the governments and society itself. We must acknowledge that there is a joint responsibility with society more broadly. There is a risk that if there were to be for instance an environmental issue, the financial industry could be blamed for not having carried out their work effectively. But issues around the environment aren't just about the financial sector but are bigger, societal issues and it isn't only the financial sector that has to take responsibility for them. Many of the ESG issues are primarily points for the government to tackle and so we need to have them create a good framework so that we can implement their decisions as investors. It is important that all these issues around ESG are not areas where society can simply shift all the responsibilities onto the financial sector.

Zoi: Which alternative strategies are being challenged in the current market and are there some which will not be viable in the long run?

Mikael: The only real strategy that I see being a challenge within alternatives is having reduced allocation in hedge funds as they have been underperforming and not delivering what they promised. This is really the only strategy that I can see having a reduced allocation in today's market.

Christian: Some of the hedge funds strategies were struggling in December. Also, the cost structure itself is based in relation to returns, which is really too high in some of these strategies. So, what we have seen is that some of the systematic trading strategies which worked well in the past, are not able to adapt their model to a changing environment.

Normally the quantitative models rely on correlations from the past. If the correlations change along with some of the regression analysis and quants behind it, in new environments, a strategy that was very successful in the past could fail because it simply can't work within the new environment in which we are now investing.

"THE TOPIC IS EVOLVING, AND WE CAN SEE ISSUES COMING MORE TO THE FOREFRONT, SUCH AS THE "GREEN WASHING" RISK AND WHAT ESG MEANS MORE GENERALLY AND ITS IMPACT"

Zoi: When you talk about hedge funds, are you looking at those which have a low correlation to other assets as being more difficult?

Christian: Yes, one of the primary reasons we invest in hedge funds is because they have a low correlation to other assets. The question is whether this is still true in our current environment. Most of the hedge fund strategies did not deliver what was expected.

Mikael: Yes, I do believe that a number of hedge fund strategies are challenged as well as the underlying structures and associated costs. In addition, there are several changes taking place inside the institutional investors' asset allocation strategies. With less emphasis put on alpha generating strategies and more on such things as smart beta. The role of hedge funds within the institutional investors' asset allocation framework has changed. The concept of adding low correlation hedge fund strategies has somewhat played out its role and institutional investors are turning elsewhere to achieve such exposure, for example increasing their infrastructure allocation. This is driven by such things such as more focus on overall costs as well as hedge fund underperformance and not doing what they were supposed to do, i.e. being more correlated to other asset classes than expected.

Zoi: What about private debt, with a focus on very long-term infrastructure lending, is this problematic?

Christian: Yes, it can be problematic in certain cases, because if you are investing over such a long period of time, can you really know what the inherent risk is on the infrastructure? In infrastructure, you have political and regulatory risk.

Certain aspects of infrastructure also combined with certain technological developments which mean that there can also be a technological risk. For instance, if you look at infrastructure for telecoms, you don't necessarily have a picture of what is needed for telecoms infrastructure in the future and so some investments will become less useful. For instance, if you compare the 5G environment, this is very different to what the infrastructure for telecoms was 20 years ago. Infrastructure is not something that is always everlasting and has to a lot to do with technology.

Infrastructure investments are traditionally very long-term. But we have to look at what can happen in the future with technological developments and changes in the environment. They can be a very good investments, but they can also be disastrous. So, you have to ask whether the risk is priced in fairly or not.

Mikael: Infrastructure debt is a newer investment strategy, and no one really knows how these structures will perform in a downturn. The data available from the GFC is based on very different capital structures and market conditions. While the perceived risk can be manageable, there is an apparent risk that the actual risk will be higher.

Going back to the concept of relative versus absolute risk and return, I believe that certain infrastructure debt strategies can be seen as attractive on a relative basis compared to low corporate and government bond yield. Taking a longer view and looking at some of these strategies on an absolute basis and factoring in a more normalized interest rate environment, they may not look as attractive. This then becomes a problem is you have locked yourself into an investment for several years (sometimes decades) without any real option to get out. The concept of entering into floating rate investments mitigates some of these issues, but the relative size of your risk premium, i.e. spread, may also be viewed differently several years out into the future.

I would also argue that that the regulatory risks have increased on a global basis, affecting the infrastructure markets. This is driven by the asset class maturing and the various regulators being more active and watchful that asset owners should not be extracting excess profits beyond what is reasonable. In addition, the geopolitical uncertainties that we are seeing around the globe including protectionism and populism will have direct and secondary effects on several infrastructure markets. For example, a recent development is that the sovereign wealth funds of certain countries are no longer welcome as buyers of certain assets in certain countries. Generally, this would reduce the competitive attractiveness of such assets and their valuations should be lower since the buyer universe is more limited than otherwise. It is hard to see that such developments were priced into historical deals and that similar future developments will be factored into the pricing of today's deals.

Zoi: Thank you for both for sharing your thoughts on this topic.

2.3 WHITEPAPER

Channelling technology to provide access – alternative finance in the spotlight

Jeff Kelisky,
CEO, Seedrs

Equity Crowdfunding (ECF) has come a long way since its humble beginnings following the financial crisis. In less than 10 years, the sector grew out of nothing to become one of the most active investors in smaller companies, accounting for 23% of the 1,572 equity deals made last year.[1]

It all started with a simple premise: to use technology to open up investment into non-public companies – in particular small and medium-sized enterprises (SMEs) start-ups – so the general public can benefit from growth opportunities that were previously out of reach. It didn't take long for investors to embrace the concept of bringing more efficiency to the sector through new technology. Between 2011 and 2017, more than £17bn in funding was intermediated by online alternative finance platforms in the UK, with £967m coming from ECF.[2]

As the market matures, it is becoming clear that alternative finance – which includes peer-to-peer (P2P) lending and ECF – continues to gather momentum and move into the mainstream. More companies are viewing ECF as a viable option for raising the funds they need, with deal sizes growing larger and more companies in the growth stage of their development choosing this method of raising capital in conjunction with or over traditional fundraising rounds. At the same time, institutional investors, such as venture capital funds, have been playing a greater role in ECF as they both seek to gain access to new investment opportunities and have their portfolio businesses tap into the associated benefits in an increasingly digitised economy.

A modern approach to fundraising

At its most basic level, ECF is a democratic twist on a centuries-old practise. Historically, entrepreneurs or early stage companies might have approached angel investors, venture capital funds or private equity firms for funding, or they may have turned to bank loans to provide them with day-to-day liquidity. More mature companies may have raised capital through an initial public offering on a stock exchange, a share issue, or they may have sold debt through the bond markets.

The problem with the old approaches to fundraising is that they often led to dead ends for both investors and companies. Retail investors were unable to access early-stage investment opportunities, while many companies struggled to raise the funds they needed to grow. This was especially the case in the years following the 2008 financial crisis, when bank lending was tight and many venture capital funds and private equity firms were holding back on making investments.[3] With traditional approaches to fundraising not being viable, many companies were drawn to the likes of P2P lending and ECF, which offered the two-pronged benefit of being able to appeal directly to their customers as well as improve customer loyalty.[4]

Several different types of P2P lending and crowdfunding platforms have evolved over the years. These include donation-based and reward-based crowdfunding, invoice trading, debt-based crowdfunding, P2P lending for both businesses and consumers, and equity-based crowdfunding. At present the Peer2Peer Finance Association lists eight P2P member companies, including the likes of Zopa and Funding Circle, while the UK Crowdfunding Association has 26 members, including Abundance, Crowdcube and Seedrs.

For investors, there are several attractions to P2P lending and ECF. For P2P lenders, the attraction was for above-average returns during a time when interest rates on cash savings and bond yields had plummeted to new lows. In the case of ECF there are many reasons, from the potentially high returns that can be earned when investing in start-up and growth companies[5] - to the fact that many investors feel it is a more engaging experience that could lead to participating in "the next big thing", as well as the simple but fulfilling act of helping new businesses and being part of their mission. In addition, for individual investors, another factor has been the tax relief available through the Seed Enterprise Investment Scheme.[6]

[1] *Beauhurst, The Deal: Equity Investment in the UK 2018*
[2] *Cambridge Centre for Alternative Finance, The 5th UK Alternative Finance Industry Report, November 2018, pp42*
[3] *Estrin, Saul and Gozman, Daniel and Khavul, Susanna (2018) The evolution and adoption of equity crowdfunding: entrepreneur and investor entry into a new market.*
[4] *Ibid*
[5] *Ibid*
[6] *Ibid*

Steady growth

The story for ECF has been one of rapid expansion, albeit at different trajectories for each model of alternative finance. P2P lenders are furthest along in the maturity cycle and continue to see impressive growth figures each year. In 2017, P2P business lenders recorded year on year growth of 66% and total transaction volume of £2bn, compared with growth of 40% and total lending of £1.2bn in 2016.[7] By the end of 2018, the UK's P2P lenders had surpassed £10bn in total cumulative lending and were lending a staggering £900m per quarter.[8]

Equity Crowdfunding, meanwhile, is at an earlier stage of the growth cycle, but the figures are no less impressive. In 2011 total fundraising for the sector as a whole was £2m. By 2017 it had ballooned to £333m.[9] What's even more impressive is how these platforms continued to achieve growth in 2018 despite it being a challenging time for venture capital funds and private equity. Despite VC and private equity investors recording fewer deal numbers than in 2017, ECF bucked the trend.[10] Not only did they set a record for the number of deals completed in a year, but they also reached new highs in terms of funding volume. Data from Beauhurst show that the three largest equity-based crowdfunding platforms in the UK completed 366 deals worth a total of £270m over the year.[11]

No longer a dirty word

A major point of concern for investors over the years has surrounded the legitimacy of P2P lending and ECF as an investment opportunity. In the early days, it was met with varying degrees of suspicion. Many were concerned about the risks involved with investing in early stage companies, while others posited that the platforms fund businesses that had no other way to raise funds. It is true that investing in early-stage private companies is a high-risk, high-return area, but most of the investors who use these platforms are aware of this fact and benefit from technology that allows them to spread those risks across multiple companies. This point is supported by research from the London School of Economics that found most ECF investors surveyed were aware of the risks involved, with many choosing to do so because they wanted to invest specifically in start-up companies.[12]

To that end, transparency and rigorous due diligence are essential. We can't escape the fact that a large number of early-stage businesses are likely to fail – independent of their source of funding. Despite this, with ECF, like more traditional funding routes, it is possible to provide investors with all the information they need so they are fully aware of the risks and rewards, as well as the features of each investment opportunity. ECF platforms go to great efforts to verify each business proposal and ensure they are not misleading investors. Standards are so high that it's estimated around 90% of business ideas submitted are rejected because they don't pass the verification and due diligence processes.[13]

It's because of the robust approach to due diligence that both P2P lending and ECF have been able to generate attractive returns for investors even during times when stock markets have followed a downward trend. While the FTSE All Share Index fell by 9.5% on a total return basis in 2018, Zopa, Funding Circle and Ratesetter all delivered positive returns to customers. Figures for ECF platforms are not as readily available, but the non-tax adjusted internal rate of return for the entire Seedrs portfolio of 577 deals was 12.02% as at 31st December 2017.

Institutional interest

Perhaps the biggest endorsement for ECF is the fact it has captured the attention of institutional investors in increasing numbers. Professional investors, such as venture capital funds and corporate finance houses, have shown a growing interest in investing in start-ups backed on ECF platforms in recent years. This has followed a similar trend towards the P2P lending market, where there is around 40% involvement from institutional investors that sought debt exposure as these platforms matured.[14]

In 2015, the proportion of funding from institutional investors ECF platforms was just 8%, but this increased to 49% in 2017. This means venture capital funds and angel investors are investing alongside retail investors through these platforms into many of the same companies.[15] The reason for this is partly due to the way the sector has matured, but it is also related to the size and nature of the companies turning to this method of raising capital. ECF delivers a number of marketing and network advantages above and beyond the capital it provides. As a result, while the platforms will always remain a place for companies in seed stage, there are an increasing number of companies seeking funding at various growth stages – and this variety is also what is attracting most professional investors.

Conclusion

There is little doubt P2P lending and ECF are now moving into the mainstream. Following a decade of development and growth, these platforms are democratising the investment landscape, enabling retail investors to participate in the same fundraising rounds as professional investors. Early stage and growth companies have greater access to funding than ever before, and we are seeing the platforms fund bigger deals each year. Not only do the platforms provide a frictionless way for consumers to invest in a diversified portfolio of seed stage and growth companies, but they are starting to become the marketplace of choice for professional investors as well. As a result, this is driving a new wave of innovation to serve that greater level of sophistication.

[7] *Cambridge Centre for Alternative Finance, The 5th UK Alternative Finance Industry Report, November 2018, pp32*
[8] *https://www.p2pfa.org.uk/p2pfa-platforms-surpass-10-billion-in-cumulative-lending/*
[9] *Cambridge Centre for Alternative Finance, The 5th UK Alternative Finance Industry Report, November 2018*
[10] *https://about.beauhurst.com/research/the-deal/ p13*
[11] *https://about.beauhurst.com/research/the-deal/*
[12] *Estrin, Saul and Gozman, Daniel and Khavul, Susanna (2018) The evolution and adoption of equity crowdfunding: entrepreneur and investor entry into a new market.*
[13] *Ibid p4; https://www.whatinvestment.co.uk/crowdfunding-platforms-carry-due-diligence-firms-2552990/*
[14] *https://www.ft.com/content/235b5198-08ce-11e7-ac5a-903b21361b43*
[15] *Cambridge Centre for Alternative Finance, The 5th UK Alternative Finance Industry Report, November 2018*

SECTION 3

IMPACT INVESTING

3.1 ROUNDTABLE

What comes first, alternative or ESG strategies: what is impact investing and what drives it?

3.1 ROUNDTABLE DEBATE

What comes first alternative or ESG strategies: what is impact investing and what drives it?

Moderator

Zoi Fletcher,
Content Producer,
Clear Path Analysis

Panellists

Jos Gijsbers,
Senior Portfolio
Manager, ASR Nederland

Rasmus Juhl Pedersen,
Head of ESG, PBU -
Pension Fund of Early
Childhood Teachers

Christian del Valle,
Managing Director,
Mirova Natural Capital

POINTS OF DISCUSSION

- *There is no standardised answer as to exactly what qualifies as impact investing, but in the narrow sense of the term it depends on having a predetermined bottom-line with social and economic goals and objectives*
- *Impact investing can be measured against positive impact on certain targets such as the Sustainable Development Goals by the UN*
- *Impact investments are put through both an impact lens and a financial return on investments lens*
- *Getting the right definition for impact investing in your investment policy as well as putting targets to ensure that there is attention to possible impact investments will help to make it more robust in your own organisation*

Zoi Fletcher: How would you define impact investing and how wide does the definition go?

Rasmus Juhl Pedersen: For an investment to qualify as impact investing it has, in the narrow sense of the term, to have a predetermined social and economic bottom line. There must be a reflection of how the investment is meant to reach both its return on investments as well as its social impact. This means that the investment needs to qualify both in respect to the returns in social and financial aspects.

Jos Gijsbers: We are still finding new ways to describe impact investing although there is a very general definition. We feel that we do a lot of impact investing already, especially within the alternatives space, but we would like to have a broader definition to ensure that we can have impact investing within all of our portfolios. We feel that asset classes such as listed equities, corporate and governments bonds should also contribute to this bottom-line approach and that it could create a positive impact.

Christian del Valle: It is very telling that this is the question we are starting with, because when we set up the Althelia Climate Fund 5-6 years ago, we became one of the founding members of the Global Impact Investors Network ("GIIN"). At most of the GIIN events in those days, one of the questions that we were all trying to answer was what exactly impact investing is, and what goes first, the pursuit of returns of the pursuit of impact. The truth is that I am not sure that there is a canon answer for this question, even today.

Now, we have arrived at a place where the notion of impact investing is beginning to take the shape of a combination of interesting and additional social and environmental outcomes paired with a return-driven strategy. This is getting more attention and focus from investors.

The fact that we don't have a standardised answer and it is not driven by any sort of regulatory based matrix, in the same way that corporate governance and AML are, means that this is still warming up and there is a lot of room for standards to be agreed and applied. But it is still very much a work in progress.

Zoi: Do you agree investors can have a positive impact when investing in bonds, and are they also part of your definition?

Rasmus: In the broader sense of the word yes. Although every investment potentially has both positive and negative impacts so of course all types of investing have an impact. In the past, we have been satisfied by the income, employment and export generation from investments being about impact in the broader sense. But, in terms of the SDGs it does call for a narrower perspective.

Christian: We are not formally active on the fixed income side. We manage a series of fund structures that are akin to private equity in some important ways. In our recent tie up with Mirova and Natixis at the end of 2017, we have since been working with the bank to broaden the investor reach (e.g. products targeting retail and high net worth clients) through some bond type structures.

The preliminary feedback we have received from the market has been very positive and we feel that there is a lot of interest there for impact investing strategies. But again, this fixed income sector is even farther behind our space in coming up with a definition for what they are actually seeking.

Without diving too deeply into our own strategy, what we seek to do is to create a parity between fair and transparent market-based returns and absolutely cutting edge, leading ESG and impact delivery, primarily on the natural capital side as well as the social side.

Some of our funds do lend themselves very well to using a bond wrapper to broaden the reach of investment euros and dollars that could be flowing into this space which is very important right now.

Zoi: Would you measure impact by how much it achieves your ESG goals?

Jos: As the definition of impact investing is already difficult, metrics to measure the impact is even more difficult. It is not just the ESG impact because the ESG policies are applied to all of our investments, which includes exclusions, ESG integration or best in class investments. Impact investments go a little bit further where the intention is important for making the investment in order to have a positive impact.

This is typically driven by a theory of change to tackle problems or to have a positive impact on certain targets such as the Sustainable Development Goals by the UN. There you also have many indicators on how you could measure the impact. When we try to define our impact investments, we also try to have a number of relevant metrics for each investment. We cannot tackle all of the SDGs, but typically you can have a major impact on 5 to 7 of the SDGs as an institutional investor. And we have a number of simple metrics available, but there isn't one standard model that measures it all.

Rasmus: It is a combination the SDGs which is something that is relatively new for us in terms of investment approaches. We have used them in the past, trying to designate how our investment stewardship dialogues with companies relate to the SDGs but in terms

“IMPACT INVESTMENTS GO A LITTLE BIT FURTHER WHERE THE INTENTION IS IMPORTANT FOR MAKING THE INVESTMENT IN ORDER TO HAVE A POSITIVE IMPACT”

of investments it is relatively new for us. We can see that this is an approach taken by more and more funds.

Zoi: Are you really investing for impact or are you investing for a good return then looking at it through an impact lens?

Rasmus: If we are looking at our entire portfolio it wouldn't not live up to the definition that I previously gave. We do have particular investments that we term impact investments where we put the investment through both an impact lens and a financial return on investments lens. For instance, we are invested in a micro finance fund and are currently looking into another micro finance fund. And when the external manager is selecting or identifying which fund to work with, they want to have assurances that it can meet its social objectives before they start looking at whether their economic objectives can be fulfilled as well.

This is a good way to distinguish between different approaches to impact investing and whether you are taking it seriously.

Jos: Firstly, we are an institutional investor and an insurance company with several stakeholders. Thus, we primarily invest to safeguard the payments that we have to make to our clients, now and in the (long-term) future. So financial returns are always a very important part of the decision process.

We are seeking to mainstream environmental and social integrity into operating models, primarily in developing countries where you have potential for conservation and agricultural production objectives to run in opposition to one another. This means that definitionally we have to deliver impact along with fair investment returns. And they are sitting at parity with each other in terms of our decision making on where to invest, how to invest and what expectations to strive for.

Zoi: Assuming you can generate more quantitative impact per Euro in alternative assets, do you start with good investments in alternatives and then see where they are the most impactful?

Jos: The impact per euro is typically higher in the private equity or private debt space. It can be efficient for us to also invest within alternative assets which are different from our standard investment approach, to build a more diversified portfolio. Like Althelia funds, as head of manager selection I also know them and was recently pitched for a co-investment by FMO for the Althelia climate fund. It's an interesting opportunity but slightly out of our comfort zone. We also prefer investments in alternatives or impact investments in more developed markets that are better accessible or less risky for investors. It may be that the impact per euro is more within the emerging markets space but the impact per euro multiplied by your investment is what makes the total impact. So, I could commit 10 million for an Althelia fund to invest in emerging markets or 100 million in a renewable energy fund in the euro zone.

“This isn't just cosmetics, as we target investments that will be successfully driven in a complimentary way both by the impact elements and the profit-based elements”

Nonetheless, we have allocated a budget for impact investing of 300 million euros per year for the next three years. So, we do pay special attention to possible impact investments. But these should also tick all the other boxes.

Christian: It isn't a matter of one or the other for us: quite simply our founding mission is to generate fair market returns as well as key impacts that are both quantifiably and qualitatively demonstrable.

We target the so-called bottom of the pyramid, and we see the UN's Social Development Goals (SDGs) as a layer cake of sorts. We have identified climate, life on land and life in the water as underpinning the natural resource base upon which the rest of human economy and society rests. Our investors across three funds have invested on the basis that we are going to invest profitably as well as continue to deliver the impact reporting that they expect.

This isn't just cosmetics, as we target investments that will be successfully driven in a complimentary way both by the impact elements and the profit-based elements.

The most impactful is a combination of the impact per euro times the number of euros that are invested. Because of the a.s.r. investment guidelines, we have most assets in developed markets, including impact investments. Like climate change for example, which is a global problem and is also caused by developed markets. So, the energy transition in developed markets is also a great opportunity to have a meaningful positive impact.

Rasmus: In terms of renewable energy, we have several investments made to renewable energy through fund investments. These investments are made primarily from return on investments and a diversification perspective. It isn't as if we have looked at which particular renewable energy investments we can make the biggest impact with and we have not been choosing between different renewable energy investments based on their impact.

In the more conscious way that we are looking at impact investments is that there needs to be both a social, environmental as well as a return bottom line which is positive and lives up to our requirements.

> IT MAY BE THAT THE IMPACT PER EURO IS MORE WITHIN THE EMERGING MARKETS SPACE BUT THE IMPACT PER EURO MULTIPLIED BY YOUR INVESTMENT IS WHAT MAKES THE TOTAL IMPACT

It is more difficult to determine which social or environmental impact is appropriate or satisfactory as this is an area where we need to have a more experienced based view which we don't currently have.

Christian: We have double-barrelled selection criteria and neither is senior to the other. Both are must-haves. We work typically with a growth strategy, less so with green field activities. We work with sponsors who have a track record and who may have been working on a model that has been primarily driven by donor or philanthropic funding in the past but are now trying to march to scale by creating a more investor friendly approach. This is where impact investing can be very useful.

Thus, when we select a pipeline and try to assemble the portfolio, we are already looking at both. At times, we start with something that at its core, is a productive activity, say livestock farming in the Brazilian Amazon. In these cases, we need to layer on investment such that you can ensure that this livestock farming maintains productivity and profitability, but where we can remove deforestation in a quantifiable way from the outcome, so that people who wish to purchase beef from these ranches know that it is deforestation-free beef and production is maintained to high animal welfare standards etc.

This is an example of where you can start with something that at its core is just a commercial enterprise but through impact investing you can layer on the social and environmental positives.

Equally, sometimes we see activities that were previously led by NGOs or donor-based initiatives that have been very powerful at delivering conservation in a finite or local area. But we feel that by incorporating elements of sustainable production with buffer zones of national parks etc., we can drive to scale and build a wider landscape level model that delivers conservation alongside economic benefits, as well as investor returns.

Issues such as climate change are global problems and in order to be a meaningful actor in delivering solutions you need to always keep scale foremost in your mind. A good impact manager can excel at doing both, bringing green to financially sound initiatives and bringing financial soundness to strong green initiatives and choosing which tactic to work with as appropriate.

Zoi: How can the industry make impact investing more robust, where it really drives investment decisions, rather than being an add on story?

Rasmus: This approach that one particular external manager takes in terms of making sure that the social and environmental impact is satisfactory before they start looking at whether they can also secure a positive financial return. This is a good way to separate and compare different investments. It makes it more explicit that it is an impact investment. When you try to portray a relatively traditional management approach and then try to align it with the UN development goals, that has the taste of an add on story. That's not an investment where you started by looking at where you could make a difference in terms of impact such as, for instance, by concentrating our micro finance on rural areas and focusing on women.

Generally, the industry needs to develop their experience as making impact investments is relatively new and there are as yet relatively few examples to learn from. There seems to be a new set of managers who offer themselves and don't have the traditional investment management background and track records. They come out of development impact with strong records in this area.

These different elements must come together and within the industry. When we are talking about impact investing, we need to know exactly what we are talking about. Are we talking about the narrow definition that I gave with the predetermined expectations on both sides? Or are we looking at impact in a much broader sense where investments have both positive and negative impacts? Ultimately, it is about reducing the negative impacts and improving the positive ones.

This covers a large stretch of different approaches so using impact investing as an umbrella term for responsible investing is one way. But a narrower and better-defined approach is to separate impact investing where you have a top and bottom line with predetermined goals and objectives.

system services each year due to the loss of biodiversity, or the fact that natural capital actually makes up around 36% of total wealth within developing countries, you very quickly get to a point where you see that if you are doing business in a way that does not take this into account, then there is a problem with the business model.

Mainstreaming ESG and impact investing is very key and, not to sound too alarmists, but we are told every year by the UN that we have about 4-5 years left at today's CO2 emissions levels before we surpass the carbon budget that keeps us to within one and a half degree of historical temperatures. So, we know that the clock is working against us. Swiftness as well as ambition are required to address this issue as quickly as possible.

> A good impact manager can excel at doing both, bringing green to financially sound initiatives and bringing financial soundness to strong green initiatives and choosing which tactic to work with as appropriate

Jos: Getting the right definition for impact investing in your investment policy as well as putting targets on the definitions to ensure that there is attention to possible impact investments will help to make it more robust in your own organisation.

We will often partner with other financial sector specialists to source impact investments. Typically, the impact is driven by a theory of change by small innovative companies who are starting up very impactful business models, which are less accessible for us. In these cases, we will typically use private equity managers, like Althelia or others, with the expertise and network to help us find the right portfolio companies. Still, these companies are in the early stages and not always very scalable. So comingled funds from professional financial organisations make impact investing more robust for our portfolios, to invest in sufficiently diversified portfolios with limited budgets.

When you move further away from the developed markets, then you also encounter political, legal, currency and other risks, which can make it difficult to make a robust investment proposition. And here it would be helpful if there were a facility for blended financing i.e. when development banks or super-nationals help us to invest in these markets and can put certain guarantees on them as well. In this case, it can become a market-consistent impact strategy, that can also compete with other private equity or private debt investments.

Christian: We feel that we need to look at both impact and sound ESG management as two sides of the same coin. Internally, we see them as key to our business and also sustainability in the wider sense. When you look at something like the 20 trillion dollars lost in eco

Jos: That is right, but it should be said that there is a lot of tailwind for these kinds of strategies. And this helps us to generate good returns so it is helpful that there is a transition going on and that you can position yourself accordingly.

Christian: Absolutely and it is not easy, and I have a lot of respect for those inside of mainstream financial services or innovations because it is difficult. I spent a lot of time working at a large bank, and to take mainstream, tailwind or not, I understand is a difficult climb, so you do have to give yourself a pat on the back because it is still going across the broader grain sometimes.

Jos: Yes, and every small step counts, so it is about continuing to take these steps in the right direction.

Zoi: Thank you all for sharing your thoughts on this topic.


ACTIVE THINKING®

SECTION 4

MANAGEMENT FEES

4.1 INTERVIEW

What is driving the lack of alignment in fees with performance related remuneration?

4.1 INTERVIEW

What is driving the lack of alignment in fees with performance related remuneration?

Interviewer

Zoi Fletcher,
Content Producer,
Clear Path Analysis

Interviewee

Tom Kehoe,
Global Head of Research,
AIMA

SUMMARY

- *With the revolution in technology and distribution and the trend towards passives, investors are hypersensitive to value for money and want to pay only for alpha*
- *Hedge fund managers do deliver on the risk return profiles being promised and continuing to be the best choice for the investor in terms of the risk adjusted returns*
- *The interests of managers and investors are increasingly aligned and are moving ever closer to what would be a fair and equitable split in terms of whatever profit that the manager earns from investing*
- *Investors need to reach an accord with alternative managers and be very clear about the performance that they are seeking within the initial phases of the on boarding process*

Zoi Fletcher: From the conversations that you're having and the research you are doing, why are investors becoming more sensitive about transparency around costs and fees?

Tom Kehoe: We did a survey last year with the global audit firm PWC and the key takeaway from this survey was that the alternative funds industry is continuing to evolve rapidly, and investors are hyper sensitive to value for money and are keenly aware of paying only for alpha, not for beta. They will only pay the type of fees that many in the industry, particularly within the alternatives industry, wouldn't have considered 5-10 years ago.

This is the result of numerous factors, one being that we have had a very bullish market in equities and so investments that have been of a passive nature have done very well. In hindsight, it has been correct to allocate to equities and those who have, have done very well off the back of them. Passive investing has certainly been the winner in the market environment that we have had, supported by the extraordinary run we have had in equities.

The hedge fund industry is experiencing a significant transformation. In the past, customers tended to use unconstrained investors such as hedge funds to achieve alpha while relying on traditional active and passive fund managers to return beta. The industry model is now being replaced by a new range of investment solutions, each tailored to the needs of an increasingly diverse investor universe. Collectively, these new solutions constitute a paradigm shift in the hedge fund landscape.

Central to this shift has been the growing influence of technology on both being able to produce investor solutions and distribute them in a more efficient way, particularly where the ability to scale some of these solutions is more prevalent.

That being said, alpha has and always will be the rarest form of returns. Given the rarity of the skills required to deliver alpha, investors will continue to pay a premium to any investment manager that can deliver this level of out-performance on a consistent basis.

This is something that passive investing has not been able to do as much of as they tend to mimic the performance of the market. But where you have other strategies that investors need, and, increasingly in the environment that we are moving into, we will need more of, investors will be willing to pay for this outperformance.

Particularly within the hedge fund industry, due to regulatory requirements and investor demands, transparency is greater than it has ever been before. The industry and its participants have worked very closely with regulators in demonstrating that level of transparency. A balance needs to be struck between an investor demanding full and complete transparency from a fund that they invest in and what a hedge fund manager is prepared to offer them

> THE INDUSTRY CONTINUES TO DEMONSTRATE THAT THEY ARE MORE THAN WILLING TO OFFER TRANSPARENCY TO INVESTORS AROUND THE TYPES OF COSTS THAT THE FIRM AND THE FUND PAYS, WHAT MAKES UP THE VARIOUS RETURNS THAT ARE PRODUCED EACH MONTH, VARIOUS LEVELS OF REPORTING AND THE REGULATORY REQUIREMENTS AND REQUESTS FOR FIRMS TO REPORT ON A PERIODIC BASIS

– from the perspective of not giving away their fund strategy's IP and disadvantaging other investors in the fund. For certain hedge fund strategies, position level transparency is not always in the best interests of the investor base.

Zoi: Are asset managers delivering on the risk return profiles being promised?

Tom: Investors have differing expectations of their hedge fund allocations. They do not always just want absolute return. Active investment strategies, as we describe them in our research, are increasingly disaggregated into three parts, alpha in its truest form, alternative beta which would include both strategy and risk premia and market beta which would be smart beta.

Investors are looking at allocating to these hedge fund strategies as a way of complementing their other investments throughout their entire portfolio. Increasingly, they allocate to hedge funds in order to replace some or all of their investments in the equity, credit, fixed income and traditional long only investments buckets. These allocations to hedge funds have demonstrated over time, to reduce the overall volatility of a portfolio's public market allocation and also offer a very attractive risk/reward return for the investor.

Other hedge fund strategies, meanwhile, can offer attractive portfolio diversification qualities through their low correlation to equity and credit markets. This can provide a higher probability of generating higher returns (albeit by taking on higher levels of risk).

Amidst the changing market cycle that we are experiencing now, with central banks globally moving to a tighter monetary bias, geo-political concerns led by more protectionist policies by US, not to mention Brexit are both creating currency tremors and inflationary pressures. I It is in instances like these that all investors need to think about what is the best solution to help them safeguard their wealth and allow them to better navigate some of the challenges. Hedge funds in all their guises fit the bill. The active part of a hedge fund still provides alpha to its investors.

It has been an excellent start to the year for the hedge fund industry, posting the strongest gains since September 2010. Within this we have had equity hedge indices i.e. the long short strategy, activist indices and special situations etc. which are all up in positive territory ranging from 3-7% in the first month alone. Risk parity and risk premia strategies have also done well.

Even taking the aggregate metrics for the year just gone, it has been a difficult period for the industry, but they weren't terrible at all given the market conditions. In fact, in the first and last quarters of last year which were characterized by the type of volatility that I mentioned, hedge funds did better than the equity indices that are often compared to hedge funds.

When we looked at this for the last year, the asset weight for composite indices for hedge funds was down 1% and net redemptions were also down around 1% on the year. At the same time, if you look under the hood of the various indices that were reported by hedge funds, the Financial Times in the last month reported on some of the best known and largest hedge funds who delivered strong, double digit returns after fees. This was in the year in which the equity indices declined between 8-10%. Some of these funds don't report into hedge fund indices so it is good to be aware of the broader picture around hedge funds.

Zoi: What is driving the lack of alignment in fees with performance related remuneration among the various alternative investment managers?

Tom: In terms of hedge funds, I don't feel that there a lack of alignment with regard to managers and investors on fees. In 2016, we published a paper, "In Concert[1]" which highlighted examples of how managers and investors are becoming more aligned in their thinking. The paper highlighted areas around what is currently being done, but also in terms of potential future developments to further improve alignment and how these could best be implemented.

The results from our survey point to managers and investors moving ever closer to what would be a fair and equitable split in terms of whatever profit that the manager earns from investing.

The paper highlights the tools that are available for the investor to help ensure that compensation, particularly the fees that are charged to investors, are structured in a way so that any profit capture is split appropriately between manager and investors.

On the performance fee side, high water marks are extremely popular. This is where the performance fee is only paid out on net new increases of the fund's asset value. There are hurdle rates that are also in place and in the paper from 2016, one third of all of those that we surveyed mentioned that they used a hurdle rate. Further clawback measures are increasingly being used as well by investors and agreed upon between managers and investors to claw back performance fees.

Managers are also crystallizing their fees, and in the main reconciling this with investor expectations. Among the managers that we surveyed, they are crystallizing fees no more frequently than on an annual basis. There are also longer lock ups in exchange for lower fees as well.

Presently we have a survey out amongst our members to explore to what extent this alignment has developed greater still. Upon closer examination of some of the early findings, managers and investors continue to explore ways as to how best to align their interests.

Zoi: What would you say to investors who say that managers are doubling the fund sizes without doubling the size of the teams; that they're making substantial gains on management fees; that they are expanding into other regions or other strategies, with the same result that they are building out the fixed fee base; but that there's less and less alignment with performance related remuneration?

Tom: I can only point to the research that we have done and the conversations that we have had across our membership and with investors. Investors are sophisticated enough to be able to meet an agreement with the manager where they will only pay a fee that they feel is worthy of the manager that they are invested in.

Our sense around fees is that it is a very competitive environment out there and at the moment the investor is in the driving seat and are able to command the type of management and performance fees that they are willing to pay.

I haven't heard of examples of what you have mentioned, which isn't to say that they don't exist, but I can only speak on behalf of the work that we have done and the conversations that we have held with both managers and investors across our global membership network.

Zoi: How can investors ensure that asset managers align their interests with them and deliver on performance?

Tom: In terms of delivering on performance, investors need to be clear to managers about what they want from any allocation that they make, whether it be to hedge funds or any other investment manager. If you have an investor who is looking for outperformance, which needs to be uncorrelated to anything else in the portfolio, then they need to articulate this fact to the investor. If they are looking for something which is just replicating the risk of the market, then this needs to be done as well.

Obviously, if a manager is delivering outperformance and they can do so on a consistent basis then this would merit a higher fee. However, if they were only matching the risk of the market then they would be charging a more competitive fee.

In our "Perspectives[2]" paper last year, we had interviews with a variety of people across the industry who felt the same. They would only pay for something where they were able to get the desired outcome. But investors do need to be clear with investors as to what they are looking for.

We have seen examples of some investors who are looking for absolute returns and outperformance but are only willing to pay a fee that doesn't match up with the demands that they have. Any conversations on fees needs to be two way which manages the expectations between managers and investors as to what kind of outcome they are looking for, the type of hedge fund strategy that they want to use and the manager they choose to achieve this for them.

Zoi: So then, it is about investors reaching an accord with alternative managers and being very clear about the performance that they are seeking within the initial phases of the on boarding process?

Tom: Exactly.

Zoi: Thank you for sharing thoughts on this topic.

[1] *https://www.aima.org/uploads/assets/uploaded/df23fb37-78ff-4d57-88859a7d70167d02.pdf*
[2] *https://www.aima.org/educate/aima-research/perspectives-research.html*

SECTION 5

GROWTH AREAS

5.1 INTERVIEW

Now that the banks have retrenched, what growth are we seeing in private debt and infrastructure and real assets, and how can we expect funds to perform?

5.1 INTERVIEW

Now that the banks have retrenched, what growth are we seeing in private debt and infrastructure and real assets, and how can we expect funds to perform?

Interviewer

Zoi Fletcher,
Content Producer,
Clear Path Analysis

Interviewee

Denis Prouteau,
CIO of Private Debt & Real Assets, Ostrum Asset Management

SUMMARY

- *The three main sectors of real asset private debt; commercial real estate, aircraft and infrastructure are seen not only as liability matching products but also cashflow generating products and this is part of the motivation for investing in them*
- *There has been a continuous trend into real asset private debt market, whatever the maturity level of investors*
- *These are very low risk asset classes and these products are structured to survive or to go through several credit cycles*
- *The vast majority of transactions within the European infrastructure market are now fixed rate, banks are working more efficiently with investors*

Zoi Fletcher: Can you explain Ostrum Asset Management's offering on real asset private debt?

Denis Prouteau: Ostrum started to be active in real asset private debt in 2012 and is now present in the three main sectors of this asset class; commercial real estate, aircraft and infrastructure.

Our offering is twofold: we have off-the-shelf products which are commingled funds in the three sectors I mentioned. They are Luxembourg based funds €-denominated for infrastructure and real estate and in US dollars for the aircraft sector. We also have a tailor-made solution, which allow us to provide ad hoc mandates through single investor funds or on balance sheet solutions in any of these asset classes or combination thereof.

We have a team of 13 portfolio managers based in Europe, Hong Kong and New York and we currently have 1.2 billion euros of assets under management. We have high ambitions as our target is to reach 6 billion AUMs by 2020.

The reason why we have such ambitious targets is because Ostrum is a major fixed income manager with the ambition of being an A-Z debt asset manager for our clients. And private debt obviously falls within this spectrum.

Moreover, Ostrum's specificity is its very strong proximity to insurance companies, which are one of the biggest investors in these asset classes. So, in working with insurance companies, it made complete sense to widen our product offering to real asset private debt.

Zoi: Who are real assets appealing to?

Denis: Initially, we felt that given the slightly longer durations and the credit worthiness of these assets that they would be mostly appealing to institutional investors who were trying to match long dated liabilities – typically insurance companies and pension funds and some sovereign wealth funds.

Whilst this has been the case and still is, over the last few years we have seen other investors looking at these asset classes not only for matching liabilities but also considering these assets as cash flow generating products. Through the amortizing nature of these assets, specifically infrastructure and aircraft, these assets give back to the investors not only a coupon and interest rates but also part of the principle that they lend. These products are seen not only as liability matching products but also cashflow generating products and this is part of the motivation for investing in them.

Zoi: What do you recommend to investors who want to access these assets that don't closely match their risk profile and liabilities?

Denis: Firstly, you need to go through something that many investors have done, which is effectively an asset allocation exercise. This is looking at the asset and liability profiles and how integrating real assets would improve the risk return profile of the portfolio. You need to go through this exercise in order to determine the proper level of duration, acceptance of risk, and currency risk to determine what asset class would make sense. For instance, if you have euro only liability, considering aircraft debt – which is US dollar denominated – would be more complicated than looking at euro denominated infrastructure or real estate.

Investors go through this asset allocation exercise and then they move to the investment phase into the asset class. This requires specific skills (that sometimes institutional investors have internalized) or investing with external fund managers. Regardless of whether you are new to the asset class or have been a long-time investor, there are a breadth of investments that can be considered within this asset class. Therefore, there are always pockets or areas that investors won't have knowledge in or will be underweight in that could be considered.

In the real asset private debt market, whatever the maturity level of investors, there is always a reason to look at it and continue to do so, so there is a bit of a continuous movement into this asset class. This is constantly shown by Preqin quarterly polls showing an ever-lasting intention to add further investments into these asset-classes.

Zoi: What growth are you seeing in real assets, infrastructure and private debt?

Denis: To address your question we need to look at each sector separately.

On European real estate, the market accounts for roughly €150 billion of yearly debt production shown to investors. You can consider this market as fairly mature. The way forward may be in importing into Europe what we have seen in the US for the last few years, which is a segmentation of the debt structure between senior products and junior tranches. As an asset manager, this segmentation would allow us to provide investors with different categories of risk profiles within our investment products. In a nutshell, I therefore don't expect the European real estate market to increase in total size per se, but in segmentation it will probably move to something similar to the US.

On infrastructure debt, if you look at it from a global perspective, which is what the majority of investors do, there is a USD 250-billion production of financing need every year and the way forward here is very much to do with regionalisation, both in terms of countries and currencies to invest into. Effectively, there are pockets of investment needs which have emerged and are now going to grow, particularly in the Asia Pacific region. So, this is why we support this trend and we have just set up a dedicated team who look at APAC infrastructure investments from our Hong Kong office.

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Aircraft is another area where the market is global, although it is far less mature than the others because it is still very much in the hands of banks. Yet the product is appealing as on top of diversification, aircraft debt also benefits from strong creditworthiness thanks to high historical recovery rate. In this market, although investors may not yet hold aircraft debt portfolios, at least within private debt, they are starting to consider it. And it will probably become the fastest growing asset class in terms of market penetration with investors but from a very low starting base.

Zoi: Given the economic and market cycle that we are coming into, how are projections for returns going forward for these asset classes?

Denis: Effectively there seem to be more and more investors who are looking at these markets because these are very low risk asset classes and these products, given that they are pledged to real assets, are supposed to be much less exposed to credit or economic cycles. They are structured to survive or to go through several credit cycles.

In terms of whether we are worried about the expected returns in a downturn cycle, so long as we continue to apply the same stringent selection criteria that we have always done, then there is no reason to be less or more worried about the asset class. The only element we consider for the credit cycle is overvaluation. For instance, for real estate in Europe, the next generation of funds are probably going to set lower loan to value criteria in their guidelines in order to take into account the fact that asset prices have actually increased in the last few years. This is how we integrate the credit cycle. It is the same selection process, but we would lower the loan to value in our portfolio so that we can take a downturn in the valuation of the assets themselves.

With regards to the impact on yields in these assets, given the loan nature and the fact that they are illiquid products, the volatility of these assets is very low. Investors actually like the low volatility feature of real asset private debt; again, these products are meant to produce cash flow, not generate capital gains. That being said, an unusual consequence of the credit cycles is that when all debt products, be they liquid or illiquid, were in high demand, the only way to have access to this market was through the primary market. With a little bit of downturn in the credit cycle in general, we now notice, on top of primary deals, where pricing is sometimes slightly affected by wider liquid credit spreads, that some secondary offers are coming to the market, mostly from banks. The reason for this has nothing to do with the asset class but something more to do with the capacity of the banks to refinance themselves on capital markets. As their visibility and conditions for refinancing worsen because of the credit cycle downturn, some banks are effectively lightening up their portfolios, starting with the jewels of the crown i.e. the best assets in their books that can be easily sold, which are the real assets private debt products. This example shows how the credit market downturn affects the real asset debt markets. This is good news for investors because it provides us with more investing opportunities, away from pure primary transactions.

In a nutshell, whilst we don't expect much of an impact on real asset private debt yields, the downturn in credit cycles means we will have more choice and will be able to effectively be choosier.

Zoi: On the private debt side, will funds be able to run as effectively when we are on a down cycle and there's a more challenging environment with more write-offs and defaults, restructurings?

Denis: It remains to be seen as to whether there are more write-offs and defaults, as we haven't seen this within our own portfolios.

These products are structured to resist these credit cycles. Investors invest in them for the right reason i.e. very long investments. It is clear from the start that these investments are held-to-maturity investments and so investors do not expect any liquidity provided by the asset managers or the market itself. This means that you avoid what you see on public markets, which is the high volatility that is sometimes triggered by forced sales or everyone moving the same way at the same time. This kind of effect does not occur with real asset private debt. And more importantly, we are confident about the creditworthiness of these assets in general because they are structured and secured properly.

When you invest in a 25-year final infrastructure, you know from the start that over the span of 25 years you will go through several credit cycles. So, the structuring of the assets and the access to the security package are going to be the way to secure your investment.

Zoi: The biggest challenge in infrastructure is finding the deals since there is a lot of money including from banks, is this set to change?

Denis: In general banks have understood that given the duration of these assets, a bank's balance sheet is not meant to be used to hold a 25-year asset. Banks have made a lot of progress working together with investors and listening to them to structure deals so that they aren't kept on the bank's balance sheet but on an asset manager's investment vehicle for the benefit of an insurance company or a pension fund.

One striking element is that 10 years ago, there were hardly any European transactions that were fixed rate transactions, because most of these assets were floating rates. This was the way banks were holding these assets on their balance sheets. For banks financing themselves in floating rate currencies, it simply made sense to hold floating rate assets. Now, banks are structuring more transactions on a fixed rate, which proves that they are not meant to be kept on the bank's balance sheet. And now around 70-75% of transactions, in terms of volume, within the European infrastructure market are now fixed rate. This demonstrates how much the market has transitioned from the banking monopoly into a chain which is efficiently working between banks and investors such as ourselves.

Zoi: Thank you for sharing your thoughts on this topic.

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