ALTERNATIVES

Moving with the times

Amid a rapidly shifting investment environment, Lynn Strongin Dodds **explores the role alternative assets could play in the European pensions space**

WRITTEN BY **LYNN STRONGIN DODDS**,
A FREELANCE JOURNALIST

Alternative asset classes are a firm fixture in a UK pension fund, but typically it is only the larger and more sophisticated European institutional investors who have holdings. Their smaller and medium-sized counterparts are interested but today's market landscape is giving many pause for thought.

Alternatives came into their own during the prolonged benign interest rate period following the global financial crisis. Real estate had always been a staple, but investors added hedge funds, private markets and infrastructure debt to the mix to generate strong returns and diversification. Fast forward to 2020 and the paradigm began to shift.

Pastures new

"It is clear we have entered a new market regime that looks nothing like the past few decades," says Newton Investment Management CIO of multi asset, Mitesh Sheth. "Deglobalisation, decarbonisation and divergence are proving to be dominant forces. Asset classes, companies and strategies are unlikely to behave as they did during the Goldilocks period, and there are likely to be different winners and losers. Therefore, it is unsurprising that globally institutional investors, are reviewing strategic asset allocation and investment approaches."

In many ways markets have come full circle. After so many years out in the cold, former favourites – government debt and investment grade credit – have come back into the fold. In Europe as well as the UK, given the sustained increases in interest rates, returns on traditional fixed income are more attractive than they have been for years, which has been reflected in allocations, particularly for European public debt and some equities, according to M&G international head of institutional distribution, Robert Heaney.

Natixis head of Western Europe, Gad Amar, also believes the denominator effect has had an impact on decision making. "No one expected equities and bonds to fall together in 2022 and for the illiquid part of the portfolio to become bigger," he adds. "We are now having more discussions about alternatives as a hedge against inflation, but the big question is over timing and when to enter the markets."

Russell Investments director of strategic client solutions, Northern Europe, Jaap Hoek, concurs, adding that the denominator effect has made European pension funds question "how much room do I have to manoeuvre? You can come up with strong opportunities, now the challenge for pension funds is how to create room in their investment plans to implement these. It might need a redesign."

Market movements

Last year not only saw the S&P 500 and the MSCI EAFE indices drop by 18.1 per cent and 14.5 per cent, respectively, but the Bloomberg Aggregate Bond Index slid by 13 per cent. The result was that investors became overly exposed to illiquid asset classes such as private equity and real estate, both of which fell over 20 per cent in 2022.

The reverberations are continuing into 2023, with Heaney flagging research from Broadridge that reveals Q1 represented the worst fundraising quarter for private debt since 2017, while real estate experienced the same fate although its previous lowest point was 2008. Infrastructure equity fundraising also suffered with a 94 per cent year-on-year decline, the poorest showing since 2009.

Given the backdrop, it is no wonder selectivity is the watchword. As Frankfurt-based WTW managing director, Matthias Paetzel, notes: "Alternatives are here to stay and those pension funds that have the experience and resources will stick with them because they do not want to lose the knowledge and resources they have built over the years. It also differs across Europe with, for example, higher allocations in Switzerland, the Netherlands and the Nordics versus Germany and Spain. The aim is to build more robust and diversified portfolios that can withstand downturns and generate returns."

This helps explain why private credit is becoming fashionable for many European as well as global pension funds. These were the findings of BlackRock Alternatives' inaugural global private markets survey, which canvassed allocators with USD 15 trillion (€13.7 trillion) total AUM. To date, this asset class accounts for roughly a quarter of AUM, but more than half of respondents globally plan to add to their private credit allotments over the next year.

Drilling down, the study revealed more than a third in the US and Canada plan a substantial increase while across Europe, the Middle East and Africa (EMEA), the figure jumps to 71 per cent. Income generation was the main reason cited by 82 per cent, followed by capital appreciation for 58 per cent. Just over 40 per cent said they would select private markets for "better ESG demonstration", while 42 per cent pointed to risk diversification.

Changing landscape

The Netherlands could potentially be a standout due to the recent radical reforms of its private pensions system – the biggest in the European Union.

Asset managers are reassessing how they invest €1.5 trillion of retirement savings, and this could trigger outflows from old favourite eurozone government bonds into riskier assets and change the way funds protect themselves from interest rate swings.

"We continue to see European pension funds focusing on private credit, primarily to access diversification and capture illiquidity and/or complexity premia," says PIMCO managing director, Robert English. "Since the inception of the asset class, allocators have predominantly focused on developing their private credit sleeves through investments in traditional corporate direct lending. This has resulted in the formation of substantial capital in income-generating products, particularly against the backdrop of near-zero interest rates."

He notes that the changing landscape and continued bank retrenchment due to stricter capital constraints has led to a surge in the interest and involvement of private capital in providing liquidity. "Pension funds are becoming more patient in their new allocations," he adds. "While traditional direct lending will continue to represent a core allocation in institutional portfolios, we are observing a growing interest in diversified and diversifying sources of private credit."

This, according to English, includes asset-based specialty finance, where the underlying investments benefit from self-liquidating contractual cashflows, floating interest rates and often hard-asset protection. "Such investments play a crucial role in either directly or indirectly funding various sectors of the global economy, including homeowners, the broader consumer population, small businesses, airlines and more," he adds. "Historically,

"IT IS CLEAR WE HAVE ENTERED A NEW MARKET REGIME THAT LOOKS NOTHING LIKE THE PAST FEW DECADES"

these assets have demonstrated better risk-adjusted returns and exhibited less volatility compared to traditional corporate lending."

BNP Paribas Asset Management head of pension solutions, Julien Halfon, also highlights infrastructure equity investments, such as utilities, transportation, and renewable energy projects gaining momentum. "These assets provide stable, long-term cash flows and are seen as a good match for the liabilities of pension funds," he adds. "They also offer less volatile exposure to an asset class similar to private equity."

LGIM head of alternatives distributions EMEA, Katherine Laurenson, agrees, adding there is still clear appetite for good quality infrastructure strategies that deliver the right outcomes. "Capital is attracted to both traditional infrastructure, such as energy and transport, and to newer social and digital infrastructure strategies that aim to support the needs of modern living and society," she notes.

Impact investing is also taking hold in private equity especially in the sectors such as renewable energy, healthcare, education and smart cities. The aim is to achieve positive, measurable social and environmental benefits and contribute meaningful solutions to the UN Sustainable Development Goals while also generating strong risk-adjusted returns.

European institutions are more mixed on private equity in general. They are looking to de-risk and limit their stakes in the wake of higher interest rates. "There is a lot of dry powder waiting for opportunities," says Pictet Asset Management head of Nordics, Elisabeth Jadal. "However, we are seeing a lot of interest in the secondaries market as well as impact private equity, which is being driven in Europe by the Sustainable Finance Disclosure Regulation and the requirements in Article 8. It was mainly in the liquid space, but we are seeing growing appetite for natural resources and carbon offset opportunities."