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Real assets guide: A changing world

Tangible benefits

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Tangible benefits

Appetite for real assets is growing among pension funds, but what makes this an appealing area, and how can investors access them? Sandra Haurant **takes a look at the world of real assets**

As asset classes go, real assets are a broad church, encompassing the likes of infrastructure and real estate, structures producing renewable energy, such as wind and solar farms, forestry and agriculture. Put simply, real assets are things that you can touch.

For pensions, real assets tick a number of useful boxes and, according to the *Real Assets Study 2024* research paper published by Aviva Investors, 69 per cent of corporate defined contribution (DC) pension funds expect to increase allocations to real assets over the next two years, up from 51 per cent a year earlier.

So what makes this collection of assets so appealing? BNP Paribas Asset Management head of real assets, Karen Azoulay, says: “Real assets provide stable and regular cash-flows – income streams for investors/pension funds; cash-flow funds, with a cash-yielding type of strategy on a long-term basis, fit well with pension fund constraints in terms of retirement pay-outs.”

Then there is the diversification question. Aviva’s research showed that 64 per cent of global institutional investors cited diversification as a primary reason for allocating to real assets today, up from 57 per cent in 2022. “This asset class is also usually considered as a diversifying asset class,” Azoulay says. “It offers diversification, either from fixed income for the investment grade type of strategies, or from alternative asset classes and equities.”

In the past, pension portfolios would primarily hold equities and bonds, and property provided diversification. Today, the scope of assets held within a portfolio is greater, but diversification is still vital. WTW head of EMEA real estate, Douglas Crawshaw, who works within the real assets team, says: “The reason one invests in diversifying strategies is to diversify away from equity and credit volatility and risks, and because of the nature of what was once just real estate, but is now real assets, they dampen down volatility and therefore act as a diversifier from a from a volatility perspective.”

A stabilising influence

In recent years, the resilience of real assets has certainly been tested, says Azoulay: “We’ve been through several situations during recent years – high inflation, the Ukraine war, and the energy crisis, for example, but our portfolios remain very resilient,” she says. “Revenues are inflation-linked. They are mostly de-correlated from traditional credit asset classes or economic cycles. So, from a macro perspective, the fundamentals are very good for the asset class, and fit well with pension funds’ investment constraints.”

And the variety within the asset class means subsections can provide different benefits. Take infrastructure, for example. Russell Investments head of strategic client solutions, David Rae, says: “Infrastructure comprises the essential assets which underpin modern economic life, and their long-term nature is a natural fit for many pension funds," he says.

"The recent experience of the pandemic volatility, highest-in-a-generation inflation and rising interest rates have proven the key portfolio benefits of the asset class, which for a long time were only theoretical; return outperformance in times of inflation and low correlation with other assets," says Rae. "At the same time, the investible universe of infrastructure has grown beyond just transportation and utilities, as more services have become essential to modern economic life – from digital communication to the energy transition to sustainable public facilities."

And when it comes to real estate, says Crawshaw, the long-term view of most pensions means they can, and do, ride out the market's cycles. "You own the building or the land, and, with some notable exceptions, nobody can take it away from you. If the market collapses, you've still got the building or the land," he says.

Premium service

The ability to take a longer-term view is, of course, essential with assets that cannot be sold instantly. "Real assets are an illiquid asset class," says Crawshaw. "I don't mean you can't sell them, but it takes time… and therefore you get an illiquidity premium,… an enhanced return, to compensate for the fact that you can't have your money back immediately."

Of course, time horizons vary depending on the life stage of a scheme, and so does the ability to absorb illiquidity; DC and defined benefits (DB) naturally have different requirements. "Infrastructure is an ideal asset class for investors with longer investment horizons looking for growth, inflation protection and the potential for a contractual income stream. Those characteristics make it a highly relevant investment for active members of DC schemes who can tolerate the illiquidity associated with this asset class," Rae says. "In contrast, many corporate DB schemes are looking to increase liquidity given their demographic circumstances and the need to rebalance portfolios."

Sturdy sustainability

ESG strategies form a crucial element of the decision-making process today; according to Aviva's research, fewer than 5 per cent of global respondents did not consider sustainability when making investment decisions, and 57 per cent of institutional investors have a commitment to net zero. But almost three quarters of institutions (73 per cent) said they wanted to prioritise financial returns when investing in sustainable real assets.

"YOU OWN THE BUILDING OR THE LAND, AND, WITH SOME NOTABLE EXCEPTIONS, NOBODY CAN TAKE IT AWAY FROM YOU. IF THE MARKET COLLAPSES, YOU'VE STILL GOT THE BUILDING OR THE LAND"

Crawshaw cautions strongly against implementing ESG strategies "for the sake of it". Pensions, after all, have specific responsibilities. "First and foremost, we have a responsibility to act in the best interest of our investors to give them the best risk-adjusted return; you [*implement ESG strategies*] to get the best risk-adjusted return," says Crawshaw.

And there is plenty of scope within real assets to do just that, says Rae, who adds: "Although [*infrastructure*] has a unique combination of exposures to climate risk (E), political sensitivity (S) and security needs (G), all of which must be mitigated proactively, infrastructure also offers tangible social and environmental benefits, even when investing solely on a return-focused basis." As a result, investors get the benefits of the asset class, while communities on the receiving end of services get the benefits of "decarbonisation, equitable internet access, essential government services, reliable utilities and safe transportation," he says.

A solid future?

Encouraging pension fund investment in the UK is a stated aim of the current chancellor, Jeremy Hunt, whose Mansion House speech called for investment into high-growth UK companies. But, Rae says that the reforms have been "interpreted more broadly to apply to private investments across a range of financial and real assets. Coupled with reform to available products, innovation and increased demand from savers, we're witnessing a change to the way infrastructure investments are made".

Aviva Investors chief investment officer, Daniel McHugh, commented on the firm's research, saying: "The findings from this year's study capture one of the most pertinent structural shifts taking place in real assets investment and retirement saving. DC pension funds represent an increasingly large portion of the pension market, yet this important group of investors have not been able to access – or allocate to – real assets as they would like, or to the extent that optimises investment outcomes." While the nature of this global asset class has made it difficult to access historically, new products – including the Long Term Asset Fund (LTAF) – may begin to lower barriers and drive up demand for those all-important assets you can touch.

BNP PARIBAS ASSET MANAGEMENT

The evolving world of real assets

BNP Paribas Asset Management head of real assets, Karen Azoulay, **discusses what this dynamic asset class can offer European pension fund investors, and explains how the firm is staying ahead of the game at a time of dramatic evolution**

Private markets investing is at the forefront for investors. When it comes to real assets, what are the main reasons for pension funds to look at this asset class?

■ **Azoulay:** We have been in this area of the market for a long time and what we are seeing is that pension funds are considering investment in private markets, and in particular in real assets, firstly because they offer an attractive risk/return profile. So, the absolute yield and relative value is interesting, and that's even more the case given the current interest rate conditions.

At the same time, real assets provide stable and regular cash-flows – so, income streams for investors/pension funds. Cash-flow funds, with a cash-yielding type of strategy on a long-term basis, fit well with pension fund constraints in terms of retirement payouts.

This asset class also offers diversification.

Why do we have these long-term stable cash-flows? Firstly, because we have inflation protection. We've been through several situations in recent years – high inflation, the Ukraine war, and the energy crisis, for example, but our portfolios remain very resilient. Revenues are inflation-linked. They are mostly de-correlated from traditional credit asset classes or economic cycles. So, from a macro perspective, the fundamentals are very good for the asset class, and fit well with pension funds' investment constraints.

Can you tell us about your real assets platform

■ **Azoulay:** Thinking about the investment philosophy behind the platform, I would highlight several key differentiating factors – firstly that we are part of a larger private assets platform. So, we have dedicated people to support our strategies. We have legal, risk, tax, ESG, and so on – that's very important.

What's even more important is that, as the asset class is quite illiquid, it's essential to have strong origination capability within the team. We actually have team members from many different backgrounds – from banks, from the industry, from the equity side, and so on – which lends itself to a very strong origination network, and that network is complemented by a privileged access to the origination capacity of BNP Paribas as a group.

The last point I would highlight is the very strong and thorough ESG process that has been, from the beginning, fully embedded into our investment process, thanks to our internal sustainability centre.

How is the platform evolving?

■ **Azoulay:** We are seeing a trend towards energy transition, as well as digital infra.

On energy transition, we used to finance straightforward renewable assets, and we are now seeing renewable assets benefiting less and less from feed-in tariffs/regulated tariffs. So, more and more merchant risk as they are now reaching what we call risk parity. This means they

do not really need any subsidised tariffs. They are competitive now. As a result, there's been a very strong move into the renewable space. So, it is very important to have the capacity to analyse those transactions.

At the same time, we are seeing new themes emerging around energy transition. For example, hydrogen, battery storage, and bio-gas. We are also seeing interesting opportunities around green mobility – rail electrification across Europe, and electric vehicles charging platforms, for instance. So, there are a lot of exciting new themes in that market.

The fact that we have been very active in energy transition since the early days, combined with the access we have to the wider group, puts us in a strong position, because we have access to industrial experts dedicated to each sector. When we decide to invest in a new sector, we have access to industry experts that are able to provide us with insight, even local market insight, through the teams all over Europe.

It is very important to have access to this local market knowledge before investing in those sectors. And when we invest ahead of market trends, that is when we pick the best assets.

Digital infra is another key area we are focusing on. That means fibre optic networks. There were plans all over Europe to bring high speed internet access to less dense areas. But that's done now, more or less. We are now seeing the refinancing of those transactions.

We've also been very active in green data centres, which are very efficient in terms of energy consumption.

Additionally, we have been active in digital towers. There has been a lot of M&A and refinancing in this field. But we have seen, despite the number of transactions, and despite the interest rate movement and all that has happened recently, those transactions have been quite resilient, and we continue to see a fair amount of transactions in that field. So, being recognised as one of the main players here is important, both for senior and junior debt.

How can pension investors play a role in financing secure and sustainable assets?

■ **Azoulay:** In the beginning, infrastructure investing was all about financing large and tangible assets that benefited from a regulated tariff or a contractual framework, relying on a public entity.

But since then, the market has evolved, because governments have less money to spend on infrastructure. So, the objective is to leverage public money, to attract private money, to use it more efficiently; and pension funds can play a key role here, investing in sustainable assets, not just so they can tick the sustainability box, but because sustainability is very much linked to the long-term performance of those assets.

It is interesting to see that there has been a change in mindset in this area among pension funds – they now understand that connection.

For example, we have launched SFDR 9 funds, and we are keeping the same target returns – so investing sustainably does not mean it is going to be detrimental to the return. Some might argue that assets are more difficult to deploy if you have strong ESG policies and constraints, but that's not the case at all.

BNP Paribas recently launched the Climate Impact Infrastructure Debt fund – what are some of the projects the fund has invested in?

■ **Azoulay:** We are focusing on several sectors, such as renewable energy, green mobility, and circular economy, as well as new energy transition-related sectors such as battery storage, hydrogen, and carbon captures. One may think that if you invest in SFDR 9, then you will only invest in renewable energy, and that's not the case at all. We can invest across different sectors. We keep that diversification as a key feature.

What are some common strategies for mitigating risk when investing in these assets?

■ **Azoulay:** The first is diversification. That's why we are not launching any thematic funds. We are focusing on funds with sectors or geographic diversification so that we don't rely on a specific regulatory framework or on a specific country situation. You want to be diversified – different jurisdictions, different market features. That's important; and having the ability to proceed with our own due diligence process, and being totally ambulant in terms of investment decisions, is key.

There's also a strong need now to have specialised skills in order to be able to analyse and invest in these new sectors. Before now, the asset class had not really evolved much in terms of sectors – we were financing transportation: Motorways, airports, ports and so on. But this has completely shifted to a new type of asset that needs very specific skills to be able to invest, because investing in hydrogen, in battery storage, in bio-gas, it's completely different. Even for the more straightforward sectors such as renewable energy, things have completely evolved.

That is why it is important now more than ever to have the internal capacity to analyse those sectors and, being part of a larger group which is at the forefront of those sectors, is a true differentiating factor for us.

LGIM

Private markets: The four key megatrends

The plates under the global economy are shifting

BY **ROB MARTIN**

Rob Martin
Global Head of Investment Strategy & Research, Real Assets

Rob is Global Head of Investment Strategy and Research for Real Assets, having joined LGP in October 2006. Prior to this, he worked for Hammerson as Head of Research, working closely with the board and senior management team on corporate, sector and asset strategies. Prior to Hammerson, Rob was at CBI for two years as a senior economist, and prior to that, he spent three years in the petroleum industry. Rob has a degree in economics and economic history.

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

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

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

1) Demographics

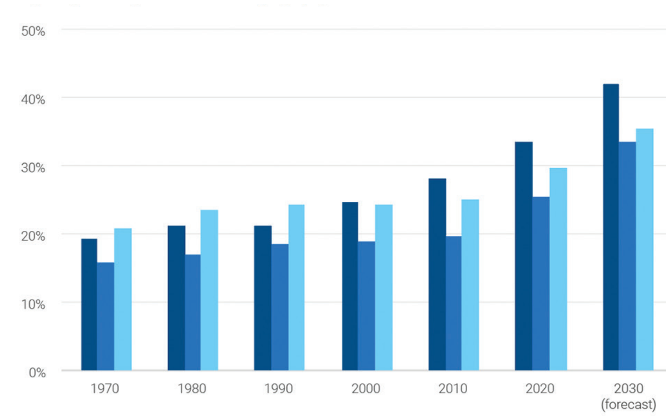
To an extent, demography is economic destiny.
Tailwinds deriving from the post-war baby boom played an important role in many major economies' development in the decades after the 1950s. Alongside a growing and healthier workforce, improving life expectancy and increasing urbanisation contributed to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

In most developed economies, this **demographic** tide is now receding. Many face the dual challenges of shrinking labour forces and increasingly elderly populations. Declining fertility rates and ongoing political sensitivities around immigration mean these issues are likely to become entrenched. In the absence of the natural boost delivered by a young, growing population, these economies will need to increase their productivity to maintain living standards.

This should in turn require greater adoption of technologies like robotics and AI, which can take the place of a shrinking workforce.

We think these trends will create

Age dependency: Ratio of working age population to over 65s



Source: World Bank DataBank as at December 2023

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

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

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

In developed markets with ageing populations (and shrinking workforces) we are already seeing increasing physical and capital requirements for healthcare facilities and technologies, and a need for more specialist accommodation for elderly communities.

From a lifestyle perspective, we expect a growing emphasis on wellbeing and leisure, which should stimulate associated industries.

2) Decarbonisation

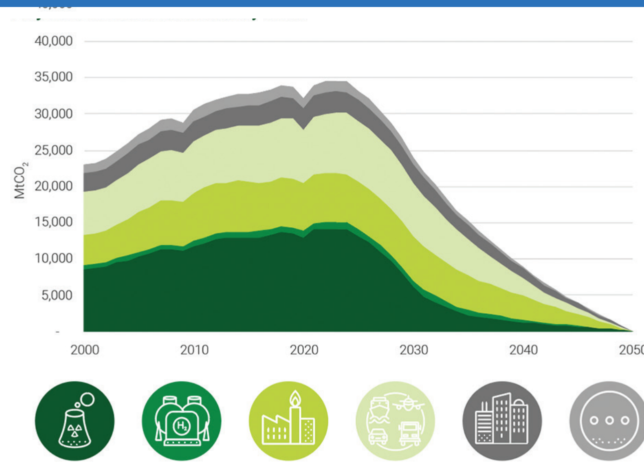
There is a growing consensus among policymakers of the urgent need to debarbonise the global economy.

According to the Intergovernmental Panel on Climate Change (IPCC), the world must reach net-zero emissions by 2050 if we are to limit global average temperature increases to 1.5oC above pre-industrial levels.

This is the threshold outlined in the 2015 Paris Agreement and committed to by almost every country in the world.

However, progress in **decarbonisation** has been patchy and global greenhouse gas (GHG) emissions are yet to meaningfully decline. One of the key challenges impeding progress is decoupling emissions from economic growth in emerging nations, where rapid

Projected direct CO2 emissions by sector



Source: BloombergNEF as at 20 November 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

increases in population and GDP have in recent decades been correlated with large expansions in GHGs released.

That said, **decarbonisation** has received significant policy focus in the EU and US, with considerable subsidies now introduced in support of constructing the infrastructure required for achieving net-zero carbon emissions. This is resulting in increased electrification as transport, home heating and certain industrial processes substitute burning fossil fuels for electricity.

Simultaneous **decarbonisation** efforts in the power sector have accelerated the buildout of renewable energy capacity, mainly in solar and wind farms. Increased deployment of renewables is placing pressure on power networks and demanding increased battery storage to deal with the intermittency of wind and solar output; addressing both challenges will require significant investment. However, constraints in technology and remaining carbon budgets will likely lead to build-out of carbon capture and storage assets in certain sectors such as cement and power generation. This is likely to contribute to a greater focus on nature-based climate solutions that can assist in offsetting the impacts of hard-to-abate emissions.

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

3) Digitalisation

The digital revolution is set only to gather pace.

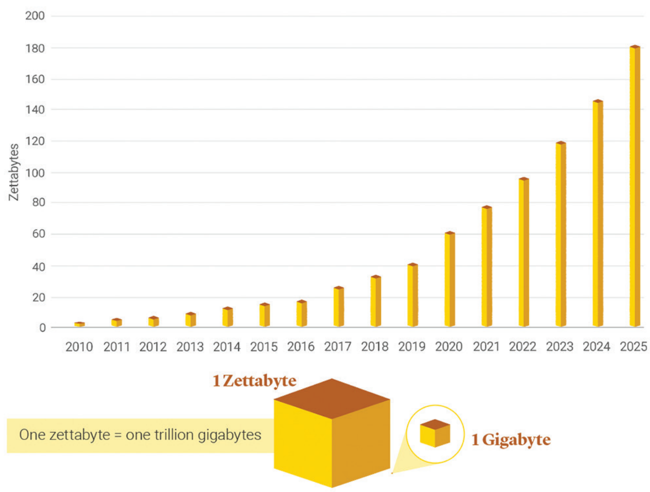
We define 'digitalisation' as the integration of new digital technologies into existing business processes[3].

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

The growth of robotics, automation and AI-assisted design is likely to facilitate the modernisation of a range of industries and ultimately deliver broad-ranging efficiency savings.

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

Data generated annually



Source: Statista, Bernard Marr & Co.
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At the same time, the enormous computational demands of generative AI alone are likely to support long-term demand for associated services like data storage, cyber-security, connectivity networks and hardware components. This should have follow-on impacts for materials, labour and real estate.

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

4) Deglobalisation

What do fraying global connections mean for private markets?

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

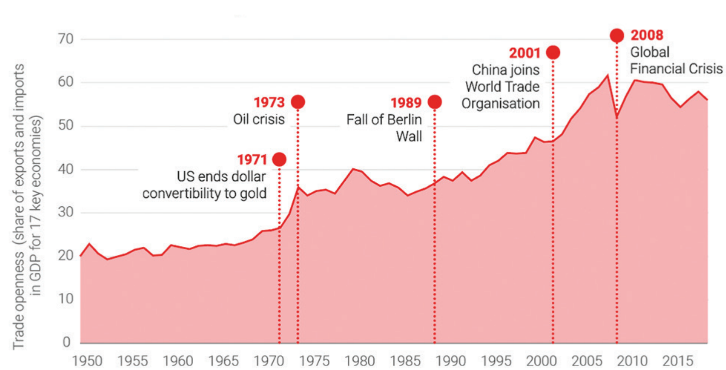
So far, we have seen a slowdown in globalisation, rather than a reversal. Nevertheless, the consequences of weakening global economic integration and political cooperation, particularly between the US and China, represents a material shift in the world's economic landscape. Growth in global trade has stagnated since the Global Financial Crisis; with protectionism on the rise, as exemplified by the USA's Inflation Reduction Act and China's weakening international trade, we believe that 'peak globalisation' may well be behind us.

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

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

The above is an extract from our recent publication: The future of private markets.

Globalisation in recent history



Source: World Economic Forum as at January 2023.
Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Company Profiles

BNP PARIBAS ASSET MANAGEMENT

BNP Paribas Asset Management (BNPP AM) is the investment arm of BNP Paribas, a leading banking group in Europe with international reach. BNPP AM aims to generate long-term sustainable returns for its clients, based on a sustainability-driven approach. BNPP AM's investment capabilities are focused around six key strategies: High Conviction Strategies, Liquidity Solutions, Emerging Markets, Multi-Assets, Systematic, Quantitative & Index and Private Assets, with investment processes incorporating quantitative and fundamental analysis.

Sustainability is core to BNPP AM's strategy and investment philosophy. Among the leaders in thematic investment in Europe1, BNPP AM intends to contribute to a successful Energy transition, healthy Ecosystems, and greater Equality in our societies (our "3Es"). BNPP AM currently manages €540 billion of assets (€656 billion of assets under management and advisory) and benefits from the expertise of more than 500 investment professionals and around 400 client servicing specialists, serving individual, corporate and institutional clients in 67 countries.

LGIM

Legal & General Investment Management (LGIM) Real Assets is a leading investor and owner-operator, fostering long-term relationships that empower us to deliver both positive financial and social outcomes. Managing over £36 billion of assets, providing pension schemes and institutional clients with investment solutions across real estate and infrastructure equity and debt as well as private credit.

Over the past several years we have bolstered our capability in Infrastructure investment, now managing £5 billion of assets across equity and debt (as at Q4 2023). We have launched a new renewable energy strategy in, in partnership with NTR, the Clean Power (Europe) Fund which is structured to allow access for both DC and DB investors. We have also demonstrated innovation in a range of transactions including marketing leading debt-for-nature swaps and first of a kind public-private partnership with a US public school system.