PORTFOLIO INSTITUTIONAL SEPTEMBER 2024

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AI: AN INVESTMENT FOR A NEW ERA

After years of nothing but failure, artificial intelligence (AI) has arrived and is living up to the hype.

It is making education and financial analysis more efficient. In medical research, the hope is that it will solve problems which have eluded the greatest minds for decades.

It is writing songs and even prepared a defendant's case in court (they lost).

So AI is changing our world and, as with all megatrends, long-term investors need to get on board. But how can they gain exposure? This month's cover story takes a look (page 16).

This edition also examines liability-driven investment (LDI). On the second anniversary of the sell-off of UK sovereign debt, have the underlying issues behind the "doom spiral" been fixed?

And what impact have improved funding levels among the country's defined benefit pension schemes had on the liability-matching market? Our take starts on page 22.

LDI also featured in our interview with the head of investing at the Pension Protection Fund. Around half of its assets are held within an LDI portfolio, so what impact has the gilt crisis had on that strategy? Read Barry Kenneth's thoughts on this and more from page 12.

We also put under the microscope carbon capture and storage's role in the fight against climate change. Does it mean the impossible: that fossil fuels and net zero can co-exist? Find out from page 42.

Elsewhere, digital currencies are seen as niche assets favoured by people sitting in pubs talking about getting rich quick, but with billions of dollars of institutional capital pouring into these funds, are we witnessing their arrival as an institutional asset class? If so, what do they bring to such portfolios? Our coverage starts on page 46.

But the more established an asset class is, it does not make it any easier to manage. Uncertainty on growth, interest rates, inflation and geopolitics mean investors have much to ponder when managing their fixed income exposures. We sat down with insiders from across the investment chain to discuss how they are positioning their debt portfolios. Our nine-page review of the event starts on page 26.

Finally, we sit down for a catch up with Faith Ward who discusses why, as head of responsible investment at the Brunel pension pool, she is getting stuck into the difficult issues as she works to make a real world impact. She speaks from page 38.

We hope you enjoy this edition.

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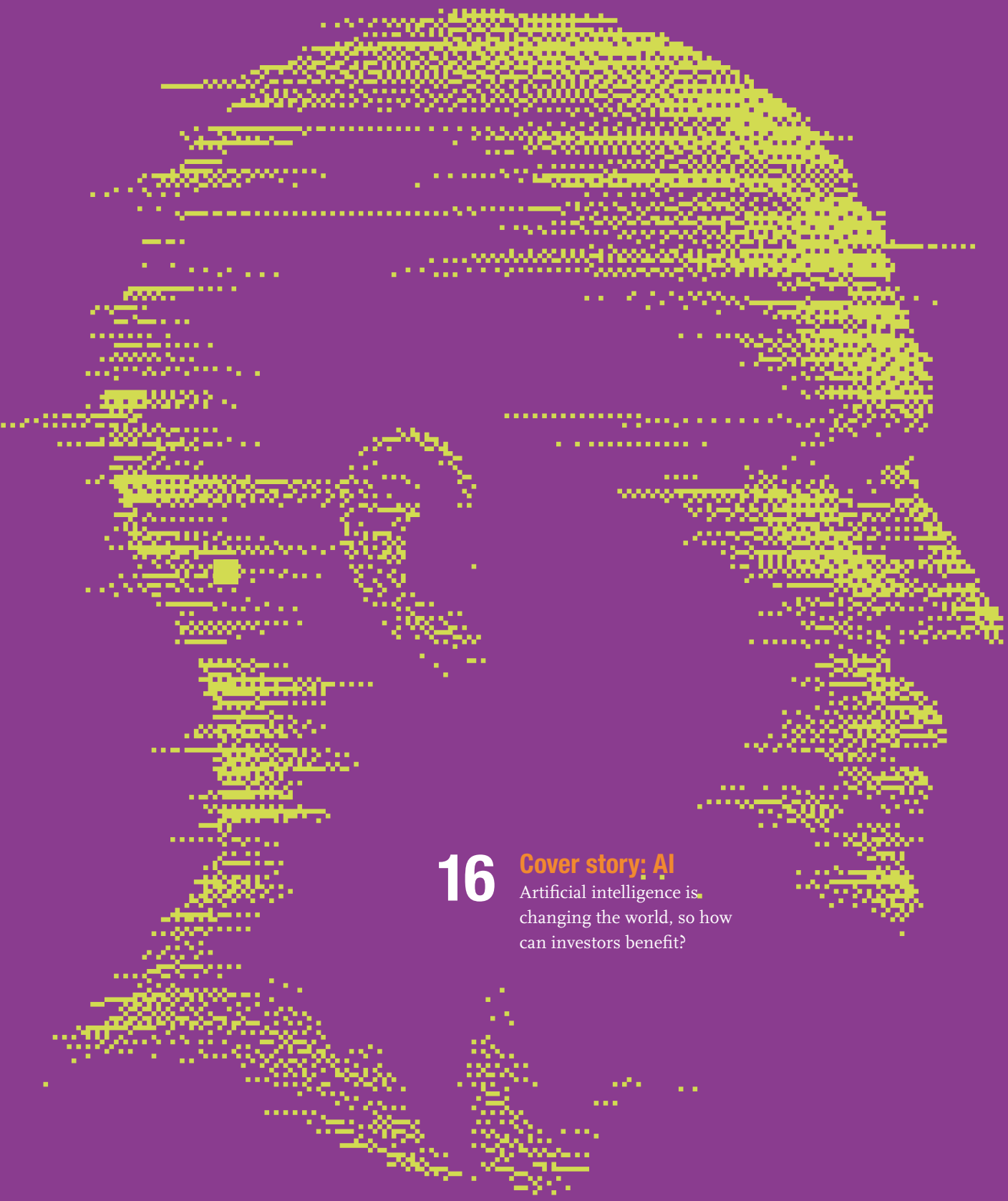


THE SUMMER MARKET ROUT: A CRASH COURSE

What lessons can investors learn from the market upheaval and what could happen next? *Andrew Holt* finds out.

It was a hot, chaotic summer in the UK in more ways than one. For investors, there was the unsettling sight of a market rout.

In early August stocks in London as well as on Wall Street and in Tokyo plummeted, prompted by fears of a recession in the US, based on weaker than expected jobs data.

Investment bank Goldman Sachs warned that the chances of a US recession had almost doubled to 25% from 15%.

This whole business was though a tad bizarre. The US is in a good place with its economy growing at 2.8% in the second quarter. In addition, the S&P500 was, until that point, up 9% in the year-to-date.

There are two interpretations on what happened. One is an excessive fascination with the latest data, according to Joe Tierney, a portfolio manager at Alliance Bernstein.

"When it comes to the ties between fundamentals and day-to-day stock prices moves, I'm not sure they have ever been more disconnected than they are today," he said.

The second points to a problem that emanates from groupthink. "The market was so certain there would be a soft landing in the US, that there was complacency that any other outcome was even possible," said Joe Davis, a global economist at Vanguard.

Too many investors had the same view of the world, he added, which has now resulted in a "repricing".

A point shared by David Giroux, chief investment officer at T Rowe Price. "It was a reminder that when there is consensus thinking, the market can turn on its head," he said.

For Wei Li, global chief investment strategist at Blackrock, the dramatic market falls demonstrated "how market narratives can swing based on single data points".

It did result in huge market panic, albeit short lived. "The ferocity of the selling was reminiscent of the 2008 global financial crisis, but without the systemic risks," said Bruce Kirk, Japan equity strategist at Goldman Sachs.

The whole business has though created investment opportunities. "We see a great opportunity to load up on more equity than we already have in our portfolio, mostly in the US because of the quality and transparency of earnings," said Dan Scott, head of multi asset at Vontobel.

A fundamental view

The shift has now turned to a more fundamental picture, of which inflation is a key component.

In the UK, inflation rose by less than expected to 2.2% in July, slightly up from 2% since June, while service sector inflation stood at 5.2%. Although an interesting fact historically is that services inflation moves much faster on the way down than on the way up.

In the US, inflation dipped below 3% in July for the first time since 2021.

"While headline inflation ticked up as favourable base effects fade, services inflation – a crucial measure of domestically generated inflationary pressure – moderated," said Aaron Hussein, global market strategist at JP Morgan Asset Management. "This coupled with moderating wage growth, suggests that inflation may finally be heading in the right direction."

There remains a risk that cutting interest rates too quickly will fan the inflation flames. "We therefore think it's unlikely that the Bank of England will follow up its August cut with a cut in September. Absent any material shock to growth, this cutting cycle is likely to be gradual with a quarterly cadence most likely," Hussein added.

Monica George Michail, associate economist at the National Institute of Economic and Social Research, is more cautious. "Underlying inflationary dynamics continued to slow with core inflation at 3.3% and services inflation at 5.2%. Despite the lower figures, these remain elevated and may lead the Bank of England to exercise some caution with regards to further interest-rate cuts," she says.

On the back of the market rout Richard Carter, head of fixed interest research at Quilter Cheviot, expressed concern about the market when it comes to judging inflation and the subsequent expected rate cuts.

"The market is potentially getting ahead of itself once again and expecting more cuts than will necessarily be delivered," he said. "The economic picture is one of a weaker consumer and businesses coming under pressure, but they remain stable enough and as such rates will not come down quickly."

Another concern is that the summer madness may not be over as we move into autumn. "We could see more volatility ahead," Wei Li said.

LPPI OFFERS CHANCELLOR ROADMAP TO £16BN OF ADDITIONAL LGPS INVESTMENT

The desire to implement Canada's Maple 8 system could unlock billions in domestic investment – if the correct lessons are applied. *Andrew Holt* reports.

The summer tour of Canada's largest pension schemes by chancellor of the exchequer Rachel Reeves has stirred more debate on what is already febrile ground. The visit was part of her plan to implement a "Canadian model" in the UK to drive greater investment in equities and infrastructure.

The Local Pensions Partnership Investments (LPPI), one of eight local government pension scheme (LGPS) investment pools, has entered the fray with the fair assertion that the government must make it easier for the LGPS to invest in the UK to realise its full potential.

This is within the context of the chancellor also signalling that her review of the pensions market will focus on "unlocking the full might of the LGPS" through greater consolidation.

But the LPPI believes any attempt at reform will only be successful if the systemic barriers to investment holding LGPS back are also addressed.

Putting this case, Richard Tomlinson, chief investment officer at LPPI, said: "The government needs to attract capital to the UK then facilitate its deployment.

"Investing in assets that will have the biggest impact on economic growth in the UK, such as infrastructure, real estate and growth capital, is often viewed as too risky for many pension funds, whose primary fiduciary responsibility is to generate sustainable risk-adjusted returns for their members."

Tomlinson then added: "We need a step-change in the pensions and investment policy environment to make investing in the UK more attractive. The government should continue on its path to planning reform, introduce formal incentives for investors in the UK, such as tax credits, and prioritise creating more domestic private market opportunities that deliver the long-term, stable returns many pension funds look for."

Tomlinson said that if these measures are followed this will support economic growth, see more pension fund capital deployed into renewable energy projects and make the government's push for greater consolidation of LGPS funds far more impactful. "Crucially, by focusing on the 'supply' of attractive opportunities the LGPS can be relied upon without compromising its long-term affordability for employers," he added.

Maple 8

For all of that, the chancellor's flirtation with the Canadian pensions system is not misplaced – if the correct lessons are learnt – LPPI suggested.

Their analysis revealed that the UK could unlock billions of pounds in extra investment if the LGPS adopted the appropriate lessons from Canada's Maple 8 – the model the chancellor is keen to use for public pension fund consolidation.

The Maple 8 system, a term referring to Canada's eight largest public pension funds, was introduced in the late 1980s and has since built up an investment pool worth $1.46trn (£823bn) – equivalent to 100% of Canada's GDP.

LPPI's analysis shows £16bn worth of capital for infrastructure could be unlocked if all of the LGPS raised their allocation in the asset class from its current average of 6% to 11% – the same weighted average as the funds in the Maple 8 system. Indeed, LPPI alone has allocated 14% of its assets to infrastructure.

LPPI also points to four key characteristics that make the Canadian model more effective than the UK's.

One is more independent governance – unlike the need for parliamentary approval for rule changes in the UK.

Two, is a greater allocation to private markets – 48% in Canada and 41% for LPPI versus just 20% by the LGPS (ex-LPPI).

Three, more effective internal management – that is by bringing a material proportion of investment management in-house to deliver increased alignment and potentially lower costs.

And four, a greater focus on long-term value creation by aligning investment decision making with the liability profile and investment goals of stakeholders.

On this, Tomlinson said: "The chancellor was right to showcase Canada's Maple 8 funds as a model of success. Public pensions investment in the UK is several years behind some of the best practice examples we've seen in places like Canada and Australia.

"We believe that presents a massive opportunity for the UK to take the best learning from these regions and potentially avoid some of the mistakes and generate significant extra investment capital for the UK.

"In addition to being able to invest in more opportunities, consolidation and contemporary governance with effective delegation could add more scale, reduce costs, remove avoidable layers of decision-making and administration, and allow investment managers to be more agile," he added.

Tomlinson then noted that LPPI began with a "Canada-like" scheme management model in 2016 and has even "outpaced" the Maple 8 in terms of investment performance.

Rachel Reeves is clear about the advantages of exporting the Maple 8 system to the UK. "The size of Canadian pension schemes means they can invest far more in productive assets like vital infrastructure than ours do," she said.

And she added: "I want British schemes to learn lessons from the Canadian model and fire up the UK economy, which would deliver better returns for savers and unlock billions of pounds of investment."

PEOPLE MOVES

Starting our round up of this month's movers and shakers in the pensions industry is the news that **Zoe Alexander** has been named as the next director of policy and advocacy at the **Pensions and Lifetime Savings Association** (PLSA).

She replaces Nigel Peaple in November, joining the board at the same time.

Alexander already works for the PLSA where she chairs its master trust committee and sits on the policy board. She is also director of strategy and corporate affairs at workplace pensions giant Nest.

Meanwhile, the £90bn **Universities Superannuation Scheme** (USS) has welcomed maths lecturer **Dr Samuel Marsh** to its board as a non-executive director.

Also reporting some news is independent trustee specialist **HS Trustees**. It has appointed former investment consultant **Bobby Riddaway** as its managing director.

He joined the board as a non-executive in July and also chairs the Haseltine Lake Staff Pension Scheme.

Finally, the **Pensions Policy Institute** has named **Dr Suzy Morrissey** as its deputy director to help create better retirement outcomes for savers.

Dr Morrissey has worked for New Zealand's treasury and was director of policy and research for the country's retirement commission.

CALENDAR

Topics for upcoming *portfolio institutional* events*

October
DC and private markets roundtable

November
Factor investing roundtable

November
Real estate debt roundtable

March
Private markets conference

May
portfolio institutional Awards

*Subject to change

NOTICEBOARD

Savings and retirement group **Phoenix** has teamed up with Schroders to launch an investment manager that could invest up to £20bn in private market assets over the next decade.

Future Growth Capital has been seeded with £1bn to invest in unlisted real assets globally. This could rise to £2.5bn over the next three years as the insurer seeks to diversify its exposures and potentially earn higher investment returns.

In accordance with the Mansion House Compact, 5% of the fund will be reserved for assets in the UK.

The **Universities Superannuation Scheme** (USS) has spent £405m on buying 3,000 shared-ownership homes across the UK from Sage Homes. The deal has seen USS create a new social housing provider, Sparrow Shared Ownership.

Also increasing its exposure to affordable housing is **Legal & General**, which has provided £75m of private credit to the **Cottsway Housing Association**.

The deal will increase the supply of social housing in West Oxfordshire, Gloucestershire, Wiltshire and Worcestershire.

This brings Legal & General's investment in the social housing sector to £1.75bn.

Staying with property, local authority pool **Wales Pension Partnership** has awarded three mandates as part of its private markets' strategy.

Schroders will manage the pool's UK core real estate investments. It will also be responsible for making impact investments in the property market, half of which will be in Wales.

And finally, the pool has handed an international real estate investment mandate to CBRE.

Access, the £45bn local authority pension pool, is looking to award two senior secured direct lending mandates.

The strategy for Europe will be worth £200m, while £150m will be available to invest in the US.

The appointed managers will lend directly to private equity-backed corporates with a focus on the core middle market.

Railpen is to fund the development of an onshore wind farm in Scotland.

The pension manager for workers of Britain's railways has joined forces with renewable energy specialist GreenPower to build the asset.

Once completed, the 66 megawatt project in North Argyll will mean that Railpen's clean energy portfolio can power more than 250,000 homes.

Also in the portfolio is the operational 46 megawatt Carraig Gheal Wind Farm in West Argyll, which the pensions manager also co-owns with GreenPower.

Starting this month's de-risking round up are the trustees of the pension scheme for the Gulf International Bank in the UK. They have hired **Isio** as a de-risking consultant. The firm will target a risk transfer with an insurer for the **Gulf International Bank (UK) Pension Scheme**.

Elsewhere, the pension scheme sponsored by high-street baker Greggs has shook hands on a £100m buy-in with **Aviva**. The deal covers most of the liabilities in the **Greggs plc 1978 Retirement and Death Benefit Scheme**.

A group of retirement schemes for the workers of an unnamed catering, retail and food service logistics specialist to the travel industry has completed a nine-figure full buy-in with **Standard Life**.

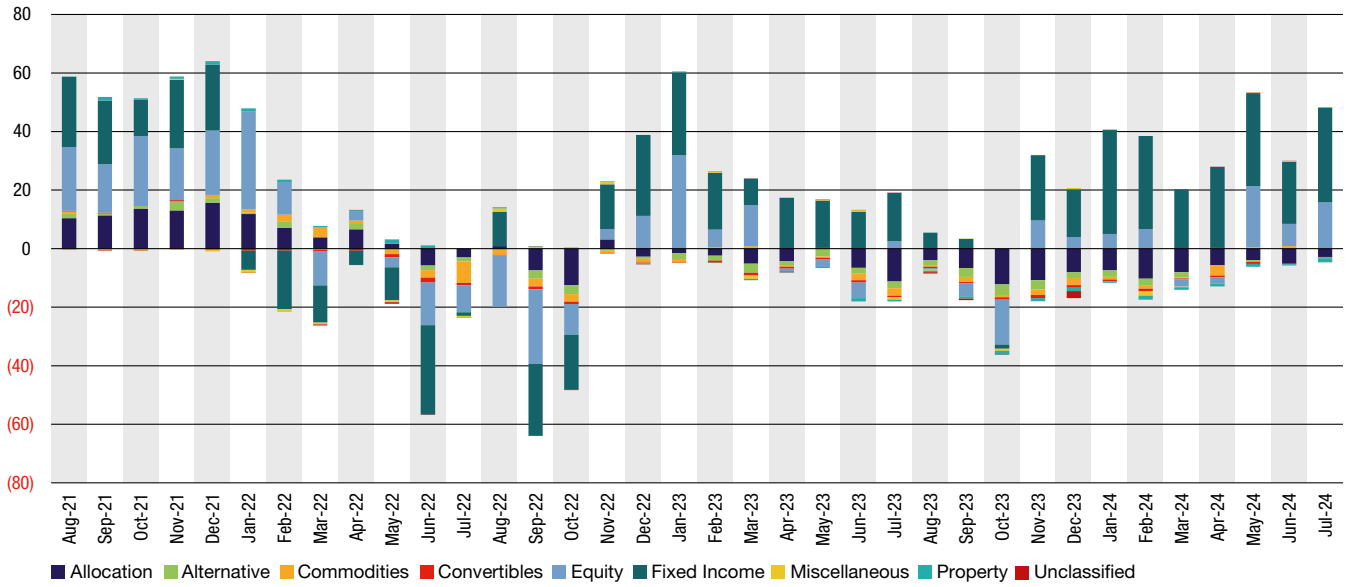
The £100m deal guarantees the benefit payments of more than 2,100 members.

Finally, the retirement fund sponsored by commercial landlord FTI Property has completed a £23m full buy-in.

Trustees of the **Rawle Gammon & Baker Pension & Assurance Scheme** agreed the deal, which covers more than 250 members, with **Just**.

THE BIG PICTURE: INVESTORS GO BIG INTO EQUITIES AHEAD OF MARKET TURMOIL

Global category group flows in the last 36 months



Currency: Euros, billions

Source: Morningstar Direct

Equity funds were popular with investors in July, but where will August's market rout leave them? *Andrew Holt* reports.

Before August's market tumult arrived, equity funds attracted €15.6bn (£13.1bn) of inflows in July, while global large-cap blend equity was once more the category that saw the largest net inflows, gaining €13.4bn (£11.2bn).

Interestingly, US large-cap blend equity funds continued to be popular with European investors, according to Morningstar.

How much the market turmoil of early August will upset these numbers going forward is a moot point.

Michael Field, European equity market strategist at Morningstar, said that the August market rout was a "sharp reminder" to investors that although economic conditions are improving, equity market gains are not a given.

"Markets have since recovered, but the psychological damage done by the rout will remain for some time," he added.

Looking at the data focused on US equities, there were some subtle but revealing changes, which experienced a notable shift away from large-cap technology stocks and a rotation to small-cap stocks, and overall, it ticked up 1.5% in dollar terms, according to the Morningstar US Market PR Index.

This potential small-cap trend could be one investors need to keep an eye on.

Meanwhile, the European market excluding UK had a more muted performance, while the UK market benefited from strong economic growth – which saw a 0.6% fillip in the second quarter – and solid service sector data.

At the same time fixed-income strategies had their ninth straight month of inflows, raking in €32.3bn (£27.1bn) of inflows in July.

At the other end of the performance scale, allocation strategies marked their fourteenth month of negative flows, with €2.8bn (£2.3bn) walking out the door, bringing total outflows this year up to a whopping €43.3bn (£36.3bn).

Somewhere in between, alternatives, returned to modest positive territory after spending much of 2022, 2023 and 2024 in negative territory, flow-wise.

When it came to green funds there was a clear division in the type of green fund that remains popular – and potentially unearths a possible indication of how the green market could shape up going forward.

Funds falling within the scope of Article 8 of the Sustainable Finance Disclosure Regulation had strong inflows of €14.5bn (£12.1bn) in July.

But funds falling under Article 9, the so called 'dark green' strategies, continued to see massive bleeding, with a tenth consecutive month of outflows, shedding €2.8bn (£2.3bn).

Overall, Article 8 funds grew over the past 12 months, albeit by only 0.26%, while products in the Article 9 group saw a negative 4.6% rate over the same period, which raises future feasibility questions about the possible move to dark green investments.

Doug Clark is head of research and solutions at Brightwell, which runs the BT Pension Scheme.

THE JOURNEY TO NET ZERO

In 2020 Brightwell supported the BT Pension Scheme (BTPS) in setting an ambitious 2035 net-zero goal. The goal was tailored to the scheme's current portfolio and future investment plans.

The scheme set a net zero by 2035 goal as virtually all members will be pensioners by 2034. As a result, the scheme is shifting its investments towards income-generating assets. This created an opportunity to re-allocate capital on a significant scale in a short period of time.

The intention was to limit the impact climate change could have on funding outcomes, providing greater resilience to meeting members' promised pensions.

At the time of setting the goal, it was recognised that a number of external factors, largely out of our control, would be critical to achieving the ambition, namely the global policy evolution, data availability and methodology challenges, and that progress would be non-linear and unpredictable.

But because of the potential impact on long-term funding, we agreed that they should not be a reason to delay. Having an ambitious goal would push us to do more sooner.

We outlined a four-pillar framework to facilitate the goal. These were factors within our control, namely: portfolio construction; managers; stewardship; and advocacy. In addition, a governance structure monitored and evaluated progress.

Almost five years on from proposing the net-zero goal, what have we learned? Over this period, arguably climate change is having an acute impact on the planet. There has been policy progress, such as the Inflation Reduction Act, but policy remains inconsistent across regions and lacking co-ordinated global action.

Data remains a key challenge. There have been clear improvements in the breath, depth and consistency of emissions data. However, there are issues such as Scope 3 data, methodology changes and weak data, particularly in private assets.

Progress on emissions has certainly been non-linear. Impacts from Covid's economic shutdowns and the subsequent recovery has resulted in a bumpy journey. Progress across countries, sectors and companies has diverged, exacerbated by different emissions management approaches taken between oil and gas companies in the US compared to Europe.

Geopolitical issues have also played a role. In particular the war in Ukraine shifting the policy focus away from emission reductions to energy security, the cost of living and a more domestically-focused agenda.

At a portfolio level we've seen decarbonisation progress ahead of the interim targets set for BTPS. This is a result of our investment managers reducing exposure to higher emitting sectors, as well as portfolio re-allocation effects which have reduced weightings to emerging markets.

However, what's clear is that a pragmatic and flexible approach is required. Data issues mean managing portfolios explicitly based on current metrics could result in suboptimal investment decisions. Moreover, a greater emphasis on forward-looking metrics and targets is required – otherwise we're trying to drive forward while only looking in the rear-view mirror.

Strong collaboration with our investment managers has been an important feature of our work over the past few years. This has been mutually beneficial, and we've seen dramatic improvements in their systems, portfolio monitoring and reporting which has allowed for deeper dialogue, greater alignment and improved clarity around how net-zero outcomes can be achieved that complement risk-return outcomes.

Positively, the opportunities to add value from the transition to net zero have opened up with significant progress in the development of investment strategies and capital targeting the transition. Critically, this has evolved from a focus on new technologies and renewables, to a wider focus that includes provision of capital to higher emitting industries that require significant investment to decarbonise. Allocating to this helps with real world decarbonisation, albeit it can lead to short-term increases in portfolio emissions.

Having a net-zero goal which wasn't too far into the future meant that we had to grapple with the nuances, implications, and challenges ahead of many others. We are encouraged that despite weaker than expected top-down global policy progress – clearly hindered by Covid and geopolitics – bottom-up progress by companies and investors has been far more positive.

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SECURING A BETTER VALUE RISK TRANSFER

The rapid improvement in funding positions for thousands of UK defined benefit pension schemes has brought forward the point at which many can realistically consider buyout with an insurer.

Higher interest rates have reduced the value of liabilities, provoking a de-risking boom that is still in its early stages with only about 15% of the £1.2trn defined benefit market opportunity so far transferred across to insurers.

Many schemes are ahead of schedule in their de-risking journey and as such need to find solutions to being invested in illiquid assets.

Investments that worked for pension schemes to help close the funding gap, and which they had planned to hold to maturity, are not necessarily so attractive to insurers. These illiquid investments can potentially hinder schemes hoping to move quickly to take advantage of today's attractive buyout pricing.

The value of the assets of a scheme are a key factor in the buyout process, but not the only consideration. By their nature illiquids are harder to sell, harder to monitor for value and may come with complex terms. Examples range from investments in real assets such as infrastructure or commercial property to the more esoteric such as private capital funds and investing in equity or debt, which may require an upfront commitment with returns distributed over an agreed lifecycle.

With these types of investments the scheme has often taken on medium or long-term obligations with no easy exit route.

Except for premiums paid in cash or gilts, bulk annuity insurers must think carefully about how assets taken on will fit into their overall investment strategy, taking into consideration additional factors such as regulation, governance and matching adjustment eligibility.

Insurers have different objectives and operate to different rules than pension schemes. Insurers need to be able to meet their long-term liabilities, and therefore have expertise and systems to manage risk positively and profitably.

For large and medium-sized schemes there is an expectation the insurer will take some or all of the assets in specie to smooth the transaction, either on a permanent basis or with a view to rotating into more suitable assets. Generally, this has been cash, gilts and corporate bonds but other assets are now being considered.

But how can schemes ensure their holdings of illiquid assets do not become a stumbling block to a successful buyout?

For trustees, being well-prepared is key to ensuring a smooth asset transfer. This involves having a clear understanding of not only the value but also the nature of their illiquid assets, and exploring the full range of solutions of how these could be utilised in a buyout. The various options will have pros and cons but can potentially be combined to reach a satisfactory outcome for the scheme and insurers.

Selling the assets on the secondary market is an obvious option but may take time and require significant discounts. It might also be possible to retain the asset and allow it to run-off before approaching insurers but could mean securing less attractive pricing at a future date.

Sponsors can play a potential role, offering loans to the scheme repayable when the asset is sold or runs-off.

Insurers may also allow part of the premium to be deferred for a period until run-off or sale of the asset.

Finally, the insurer may agree to take on the illiquid asset in specie, typically at a discount but helping to avoid the problem of forced sales. But in order to take on these assets the insurer will need significant information on the assets, and ideally early in the process.

Whatever the solution, it is important that the scheme trustees and their advisers work together. Risk transfer specialists who often lead the brokering process will need to lean on the expertise of investment advisers to navigate these complex scenarios. And it is best if this is done before approaching insurers.

A well-prepared, proactive approach can help unlock better value for schemes and avoid pitfalls, additional expense or delay during the transfer process.

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INTERVIEW – BARRY KENNETH

"I still believe there is some market rebalancing to be done."

The chief investment officer of the Pension Protection Fund (PPF) tells *Andrew Holt* about having an investment thesis, the real cause of the gilt crisis and being calm and methodical.

We last spoke during the gilt crisis. Looking back, how well did you cope during that period?

We saw it as an opportunity, rather than a problem.

Our LDI strategy worked as we expected, and given we have a very professional and experienced market-facing team with total control over the strategy, we were able to utilise all the tools at our disposal to manage the exposure and any associated collateral requirements. So, the gilt crisis didn't cause us any issues at all. Our risk framework is well thought out and extremely robust.

On the opportunity side, we picked up an awful lot of corporate debt at the time. We bought about £1bn worth of short-term investment-grade credit. The market was stressed, so we used it as an opportunity to buy assets at attractive levels.

At the same time, we helped a lot of banks free up risk capital in order to continue to facilitate some pension funds getting liquidity.

So LDI helped rather than hindered the fund?

Because we didn't have to worry about the fund, we could spend time looking for buying opportunities. Which we did.

What impact did the crisis have on your portfolio? You had about half of it in LDI.

Our balance sheet is split into two portfolios – a matching portfolio and a growth portfolio.

The matching portfolio aims to replicate the interest rate and inflation risk of our liabilities using investment-grade debt: public and private, government bonds and swaps. That is roughly half of our assets.

It is not just a traditional LDI portfolio because it also has an allocation to investment-grade credit securities. There is a plan to fully fund this portfolio over the next 10 years, with annual injections from the growth portfolio, which holds the other 50% of our assets. These are the riskier assets: equities, private equity, real

estate, infrastructure and hedge funds – those kinds of assets. These are long-term investments that are expected to generate a higher return than the matching portfolio. This portfolio is intended to conservatively build reserves so we can absorb the impact of future changes in our balance sheet – claims, compensation changes, longevity, which may increase our liabilities.

Have you introduced any new assets into your portfolios?

We already have a broad investment universe to be fair. We invest in equities, private equity, infrastructure, farmland and agriculture, investment-grade credit, emerging-market debt, hedge funds and cash. So pretty much the length and breadth of the asset-class world. The only thing we don't invest directly in is commodities.

And I stay away from what I would describe as non-fundamental investment propositions, such as crypto currencies, which do not trade on fundamentals.

We look at each investment proposition together with the thesis on returns. We must be able to estimate an expected return and understand how the asset can generate this return and buy into the proposition. It is difficult to project an expected return on investments such as insurance-linked securities and crypto currency.

Compare this to an infrastructure investment proposition, for example, where you can analyse what is being constructed, model the future cashflows and understand where the returns/risks are coming from.

So, we need to examine and understand the fundamental investment thesis before we can buy into it.

It doesn't mean we have a narrow or restrictive investment range, it's more the investment belief. We invest in hedge funds, for example, but the underlying assets they trade will be those that we are familiar with and are understood by us.

Going back to LDI, some critics say the crisis exposed such strategies, particularly those that were highly leveraged, and it has had its day as a result. What's your view?

I don't think that is true. LDI is a misused phrase. What has happened is that people have ended up classifying and categorising LDI in different ways. LDI in its simplest form is investing in assets to match your liabilities.

The problem in the LDI crisis was not the movement of the interest-rate market, the problem was the operational management of actual LDI programmes. This needs to be robust. If you are investing in swaps as part of your LDI strategy then you should hold enough collateral such that if the underlining market moves by a certain number of basis points, you have enough eligible collateral to cover the margin call. Some didn't.

Part of the issue was that post-2008 many of these collateral arrangements changed, to be more restrictive. I suspect the operational frameworks used by some asset managers have not evolved sufficiently to cope with the ramifications of these changes. People can point towards regulators or inappropriate LDI programs, but I believe it was the operational management of these programs and clunky – slow, inflexible, inefficient – governance which is predominately where the problem lay. These programmes hadn't moved with the times.

Is that the biggest lesson you have taken from the crisis?

Yes. The key lesson is on operational management of these complex programmes. It was predominantly the small pension schemes that were hit, given they did not have the governance to react quickly.

So smaller pensions funds should not touch LDI?

Trustees have a responsibility to understand what they are buying, but consultants should have also understood what could go wrong and advised accordingly. It's difficult to generalise.

There has been a parliamentary hearing and much finger pointing about that crisis. Where does the wider blame lie?

It is probably easy to comment on this in hindsight, but there were clear operational inefficiencies. If there is insufficient collateral on hand to be readily transferred, then governance between the pension funds themselves, consultants and the asset manager, needs to be much more agile and flexible – this is the benefit of having our own LDI programme run in-house. In the end, eligible collateral did not move quickly enough to pay margin calls.

Effective risk measurement and management is central to your portfolios. Why is this so important?

It is important to have a robust risk framework as this determines how we invest.

My job is to make sure the fund is positioned for all market eventualities.

Our risk framework covers many types and layers of risks from balance sheet risk, asset class risk all the way through to liquidity risk – these are evaluated mathematically and intuitively. If the framework is created well, then we have the risk controls and processes to navigate through stressed situations.

Everything we do at the Pension Protection Fund is governed by risk management. Even when we review the strategic asset allocation, our process starts with the long-term expectations for risk, as well as return, for each asset class.

We also have other controls: compliance controls and risk controls, in terms of how much risk we can take on. The key point to make here is that conscious risk management is embedded throughout the entire investment process.

Has that been one of the successes of the fund overall?

Yeah, but there are a number of things that contribute to the success of the fund. One, there is the existing risk framework.

Two, we have experienced investment professionals working within this framework throughout the fund.

Three, we also have different types of mandate.

Four, we then have a good level of diversification for the level of risk we take, so we do not have too much concentration on individual positions.

And five, my job is to make sure the fund is positioned for all market eventualities.

What is your approach to responsible investment and ESG?

ESG has been ingrained in our investment portfolio and investment process since even before I arrived [in 2013]. However, the bar for our ESG targets and objectives has moved higher and higher, year-on-year.

We regularly engage with our managers and have a fundamental exchange of views on how we expect our ESG criteria to be applied to our portfolios. Our asset managers must abide by our ESG and responsible investment requirements, stewardship practices, which we are heavily involved in, and include engagement and voting activities, as well as exclusions and reporting. They must be comfortable with, and fulfill, all that.

We have not, though, set any big [net-zero] targets. Our approach is to move the bar higher and higher, over time, for our responsible investment criteria and ESG beliefs. Targets are predicated on the investments you make and, importantly, are reliant on the government's plans to become net zero. No one can definitively say we will be net-zero in five years. So, we look for evidence-based analysis and we take a risk-adjusted approach towards responsible investing.

Another key point to make is that ESG risk is mitigated through our responsible investment framework, which integrates ESG considerations and active stewardship. This includes conducting rigorous due diligence during the manager selection process and then ongoing monitoring of portfolios versus our ESG objectives.

Are there any political and economic issues and trends that concern you?

A lot of risks around the world at the moment are geopolitical and have been for some time. And much of the market is complacent about those geopolitical risks, so it is something to keep an eye on.

Looking at what is ahead, if you look at what is going on in the States, with Trump and Harris, there are two different views on the running of the economy, on protectionism and also on ESG and climate risk issues, which presents challenges.

The inflation conundrum is still there because of the geopolitics, because of the price of commodities and oil, which began with the war in Ukraine. Although it is not something we can do a great deal about. We just need to be cautious and suitably diversified in our investments.

Economically, we have effectively gone from one crisis to the next: the financial crisis of 2008 and then we had Covid. So, we have not had a consistent economic picture.

And I still believe there is some market rebalancing to be done. Geopolitics is likely to be a big driver of that.

How do you view the new government and its various initiatives?

Like the last government, there has been a lot of discussion around the growth of the economy and in relation to pensions, to get capital invested in the UK. Ultimately though it has to be investment in the right projects, for pension funds.

While it is true that prosperity is created by growth, the [government's] push towards home-biased investment does not necessarily align with good portfolio diversification.

What has been the biggest lesson of your career?

When you are dealing with investments and markets you have to be calm, look at the facts, and make methodical decisions. If you are able to do that, you will come out of it well. You have to ignore the noise and focus on what is fundamental and in front of you to make logical decisions.

Having a solid framework to work within will help you make those logical decisions. You have to keep in mind that no one has ever bottled up a secret sauce where you can make money all the time.

BARRY KENNETH'S CV

June 2013 – present

Chief investment officer

The Pension Protection Fund

June 2004 – June 2013

Managing director

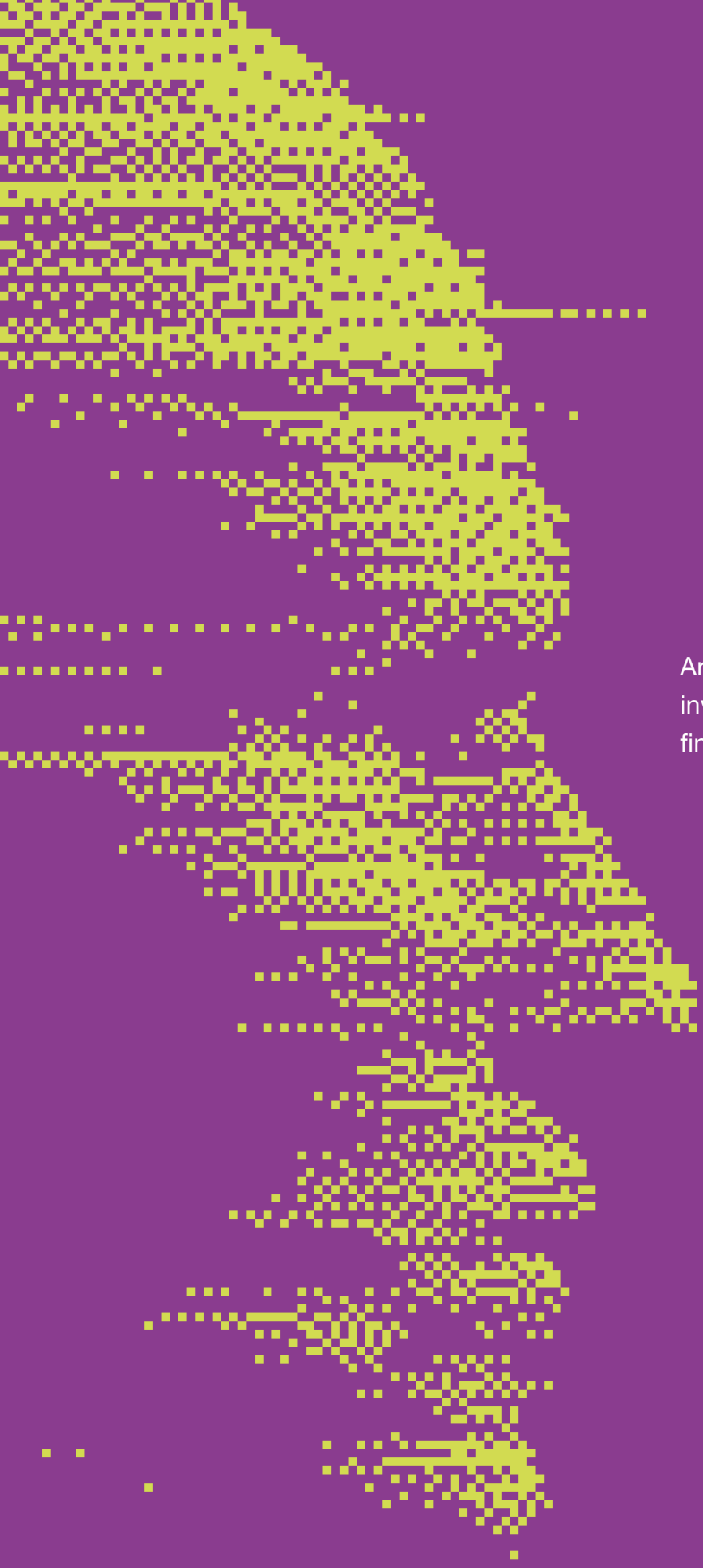
Morgan Stanley

October 1995 – March 2004

Director

Royal Bank of Scotland

AI: AN INVESTMENT FOR A NEW ERA



Artificial intelligence offers institutional investors an array of opportunities, finds *Andrew Holt*.

The development of artificial intelligence (AI) is one of the most talked about issues of our time. Usually anxieties about its development dominate many discussions, and regularly form the basis of some dystopian future when it comes to adopting it within a narrative.

From an investment perspective, however, the future is far more upbeat when it comes to AI and robotics.

In fact, the rise of such an innovation has become the investment theme most cited by institutional investors. And this usually involves the N word – Nvidia – which is an ever-present reference within the AI debate for obvious reasons.

Indeed, anyone who doubts that AI will change our lives should take a look at Nvidia. It makes the chips that AI applications run on. In its latest quarterly earnings, the company reported revenues of $18bn (£13.7bn) – an increase of $12bn (£9bn) against the same three months of the previous year. Analysts are forecasting that in just two years, Nvidia's annual revenues will have grown by more than $60bn (£45.7bn).

If that much is being spent on the components that enable the technology to be deployed into real world uses, it seems fair to assume that quite a lot of change is going to happen. There will be a few big winners within this: processor designers, hardware producers, datacentre operators and all that.

"For me, it is the potential for companies to up their returns by deploying the technology to cut through bottlenecks and lift service standards that is most exciting," says Steve Clayton, head of equity funds at Hargreaves Lansdown.

Whole new product categories are emerging. Microsoft's Copilot costs $30 (£22) per month but reportedly can boost productivity by far, far more. So one day, we could potentially see hundreds of millions of workers using Copilot. That could add up to a lot of GDP growth and a lot more revenue for Microsoft.

Hargreaves Lansdown holds positions in Microsoft and Nvidia.

"These businesses are some of the core beneficiaries of the early stages of the surge in AI development," Clayton says.

An AI promise

AI has been stealing the limelight for good reason as it promises to turbocharge the power of the digital economy by making systems smarter.

The range of sectors AI will influence is also vast. "In healthcare, AI can help to boost accuracy and output in areas like radiology by highlighting areas that need particular attention by the radiologist and speeding up the interpretation of scans," Clayton adds.

Connecting sensor data gathered in hospital wards to AI engines will enable earlier interventions by medical teams. The possibilities are huge. "Deploying AI into real-world situations will lead to more digital equipment, from sensors to servers being required. Digital businesses will be more capable and require more capacity as a result," Clayton says.

> **Despite witnessing the phenomenal growth of AI infrastructure businesses, we are convinced that many investors do not fully comprehend the improvements in AI models that are yet to come.**
>
> Jonathan Curtis, Franklin Equity

And on the road cars will have more tech in them, they will be smarter and possibly safer as a result. Aptiv is one of the largest manufacturers of core electric vehicle components and intelligent electronics for the new generations of automobiles.

And in a broader sense, technology is ubiquitous across economic activity providing new investment opportunities for investors, the most recent of which is the transition from digitalisation to artificial intelligence in the services sector.

"We have seen the acceleration of autonomation through AI, notably several industrial companies have spent heavily on robotics and automation in order to improve output quality across their production workflows," says Marco Barresi, equity research analyst at Lombard Odier.

"This trend also includes 'embodied Al', which focuses on how technology interacts with the physical world, typically as a robot or 'cobot' (collaborative robot), including autonomous vehicles and drones," Barresi adds.

Robots can use Al to learn from their own interactions with the world, and to show conversational and situational awareness as their abilities to read labels, interpret signs, understand shapes, calculate volumes or package objects improves. This is driving a shift from automating simple tasks to autonomous machines, according to research by Intel.

"While AI has been around for years, we are on the cusp of a major inflection point as the various prerequisites are reinforced by the growing infrastructure behind data centres," Barresi says. This is illustrated, he says by the "tremendous increase" in semi-conductors designed to support AI's architecture.

"We expect this infrastructure-related spending to filter down into devices – smartphones and desktop computers – that access networks, and where most data is generated," he adds.

High-paced innovation cycles will spur new use-cases across many sectors, thanks to customised solutions based on differentiated industry know-how and proprietary data, Barresi says. "This offers investors plentiful opportunities to benefit from exposure to well-positioned companies in the AI value chain."

Moreover, business intelligence and analytics, increasingly powered by AI will now remain, or become, a top priority for investment as enterprises continue to digitise and consumer behaviour shifts towards digital channels, he adds.

Big change

Yet many institutional investors do not fully grasp the changes, according to Jonathan Curtis, chief investment officer and portfolio manager at Franklin Equity. "Despite witnessing the phenomenal growth of AI infrastructure businesses, we are convinced that many investors do not fully comprehend the improvements in AI models that are yet to come," he says. "They also do not foresee how these improvements, once employed, will enable innovation, accelerate growth and boost the efficiency of the global economy."

Curtis adds that in his view, we are on the cusp of radical change as models evolve from text-centric chatbots and media creation engines to active agents.

"These agents will be able to reason and use computers, behaving more like the world's most advanced human digital workers, such as scientists, mathematicians, programmers and AI researchers. We believe this is when innovation, growth and efficiency will begin to accelerate in a meaningful way," Curtis says.

It will all contribute to change in some shape or form. Zehrid Osmani, head of the global long-term unconstrained team at Martin Currie, highlights three "seismic thematic shifts" that are likely to shape investment opportunities and will be structural growth drivers over the next decade and beyond.

These are the energy transition, the ageing population and artificial intelligence. "Artificial intelligence will influence all three of those, in a broad sense," Osmani says.

New themes

The nature of artificial intelligence is changing things so dramatically that different theories emanate from it. Osmani foresees four themes as being important for investors in this regard: one is technological and geopolitical fragmentation; two is cloud infrastructure and cyber security; three, robotics and automation; and four, metaverse and quantum computing.

"Robotics and automation is a rapidly growing structural trend, which has been further boosted by the advent of AI. It will lead to a rapid take-up of smarter robotics, more autonomous automation, and various enhancements in industrial and services sectors," Osmani says.

As part of this, Martin Currie forecasts robotics and automation to grow at a compound annualised growth rate of +25% over 10 years, which highlights the immense magnitude of the growth opportunity for investors.

"As we get into a future of robotics and automation interacting in a more ubiquitous manner with humans – think autonomous driving, autonomous robots, etc – there will be a need for faster computing power, which means that companies such as Nvidia are well placed to capture that structural growth segment," Osmani says.

AI pyramid

Tom Riley, lead portfolio manager of the AXA Robotech strategy, believes the AI Investment universe looks like a pyramid, split in to three main areas of infrastructure, technology and applications.

The investor focus is at the bottom of the pyramid – the infrastructure and technology segments. These are the semi-conductors and the hardware used to build AI ecosystems as well as the cloud computing platforms on which they run.

"At present, it is particularly the infrastructure areas where companies have seen the most immediate impact and share

We believe physical AI could become the next major wave in AI and enable the digitalisation of heavy industries.

Tom Riley, AXA

prices have risen the most over the last 18 months," Riley says. Currently, the applications are more limited, the development of Generative Artificial Intelligence and Large Language Models (LLMs) – such as ChatGPT – are at the early stages of commercialisation, Riley says. Indeed, the true range of applications of AI are still to be determined.

"In the coming years, we believe the pyramid should invert as the opportunity for applications of AI become more significant," Riley says. There are parallels here with other technology changes – mobile internet, for example – the hardware companies derived some value from these technology shifts, but the real economic value was created in the new businesses which leveraged 3G, 4G, 5G – social media, ecommerce, streaming and the much used Ride Hailing app to get your Uber.

"Many of the beneficiaries will be outside of the technology sector, so traditional technology investment funds may not be positioned to capture all of these opportunities," Riley says. "'Robotech' should be sufficiently flexible to capture many of the most exciting AI-enabled opportunities across the economy."

There are therefore other extension areas for investors to consider within this, particularly in the rapidly growing area of robotics.

For example, factories worldwide introduced a record number of industrial robots in 2022 – a total of 553,052, 5% more than in 2021, according to the International Federation of Robotics. Between 2023 and 2026, the market is expected to grow by 7% per year.

The investment universe for robotics and AI is much broader than most people anticipate, with opportunities in industrial applications, transportation, healthcare and the technology enablers. "We see AI moving into the warehouse automation space and have investments in companies that have autonomous bots that move around warehouses collecting packages," Riley says.

"In the transportation space we are getting increasingly closer to breakthroughs and adoption of autonomous driving applications," he adds. In the healthcare space, Riley says there is huge amount of development going on in the robotic-surgery space.

The leading provider in the healthcare space, Intuitive Surgical, which carries out around 2.5 million surgical procedures per year, has just announced a new robot for the first time in many years. This Robot has 10,000 times the compute speed of the prior generation.

And perhaps the most important are the technology enablers. "These are the semi-conductors, the sensors, the software, the AI that drives the growth of the industry," Riley says.

The growth of the robotics industry has accelerated over the past decade due to new technologies allowing machines to serve new markets. "We believe that AI should be a further catalyst to drive this going forward," Riley adds.

But this is a particularly interesting time to be looking at the area as three things are happening at once: one, the structural growth of the industry continues. Two, the technology change from AI supplements this growth opens new markets. And three, a cyclical recovery emerges for the first time in many years.

Alongside more traditional robotics, there are headlines at the moment on the concepts on physical AI and humanoid robotics. "These concepts are in their infancy, so we would be cautious in making too many predictions here, but they are interesting developments to monitor," Riley says.

"We believe physical AI could become the next major wave in AI and enable the digitalisation of heavy industries," Riley adds. Physical AI – or AI that understands the laws of physics – is crucial for robotics and industrial digitalisation.

And guess who is a pioneer in this area? Yes, it is Nvidia. Their Omniverse simulation platform and its Isaac robotics platform are being adopted by such key industry participants as Delta Electronics, Foxconn, Pegatron, Wistron, BYD Electronics, Siemens, Teradyne and Intrinsic. "This is essentially the AI version of the next industrial revolution that remains ahead of us," Riley says.

"We view the focus on physical AI at its flagship conferences by Nvidia as encouraging," he adds. The growing number of partnerships Nvidia has within the industrial sector and the breath of markets covered help raise the opportunity for potential breakthroughs.

Harnessing robotics

Significant advances in AI coupled with labour markets that continue to be tight are ramping up the use of automation, as an ever-rising number of companies increasingly harness robotics to bolster efficiency, safety and precision, Riley says.

The car industry accounts for around a third of all robots in factories worldwide and most car manufacturers use automation at nearly every stage of vehicle production, with battery manufacturing for electric vehicles proving to be a large new market for automation technologies.

"Exciting developments in the use of artificial intelligence to develop electric vehicles, as well as cars that can optimise fuel usage, navigate in real time, alert drivers to maintenance issues and even drive autonomously," Riley says.

Driving all this are software, semi-conductor and other key component providers. "The use of robotics and automation can reduce costs and increase efficiency, quality and safety," Riley says. "Connected or smart factories can gather and assess data which can optimise processes, helping manufacturers respond swiftly to changing demand, as well as recognising problems before they cause wider disruption."

Some of this has happened faster due to Covid. The pandemic boosted demand for online shopping and meant many retailers and distributors needed to scale up their fulfilment of orders, increasingly turning to automation. "From Amazon to Ocado, companies are using warehouse robotics for managing orders, picking, sorting, packing and more – and this market is forecast to almost double from $12.9bn (£9.8bn) in 2023 to near $25bn (£19bn) in 2028," Riley says.

New and old

But it's not just a case of new innovations. Investment in new technologies is coming as manufacturing systems age, in the US in particular.

"Across manufacturing, US machinery is the amongst the oldest it has ever been," Riley points out. "The average age of manufacturing capital stock is 11 years, according to 2022 data, compared to an average of eight years over the past several decades, indicating that upgrades are imminent.

"Industrial companies worldwide expect to spend heavily on robotics and automation, led by logistics and fulfilment firms," he adds. "But successful implementation is a concern among businesses, suggesting the most successful robotics and automation providers will be those that can help their industrial clients overcome the challenges."

The combination of changing consumer and corporate demand, and the backing of new government policies like the Inflation Reduction Act (IRA), means a considerable potential boost for the robotics and automation sector.

"As demands for technology become more complex, we see potential investment opportunities in semi-conductor firms, such as Nvidia and Taiwan Semiconductor Manufacturing Company, that innovate to keep pace with these changing needs," Riley says.

Meanwhile, sectors that are at the forefront of harnessing the benefits of AI, including much cited transportation and healthcare, look set to continue to benefit as the use of robotics and automation becomes further embedded.

"We believe the robotics and automation sector is a significant growth market, and one where we are still in the fledgling stages of its development; not only in terms of its expansion potential but also in terms of the long-term investment opportunities it presents," Riley says.

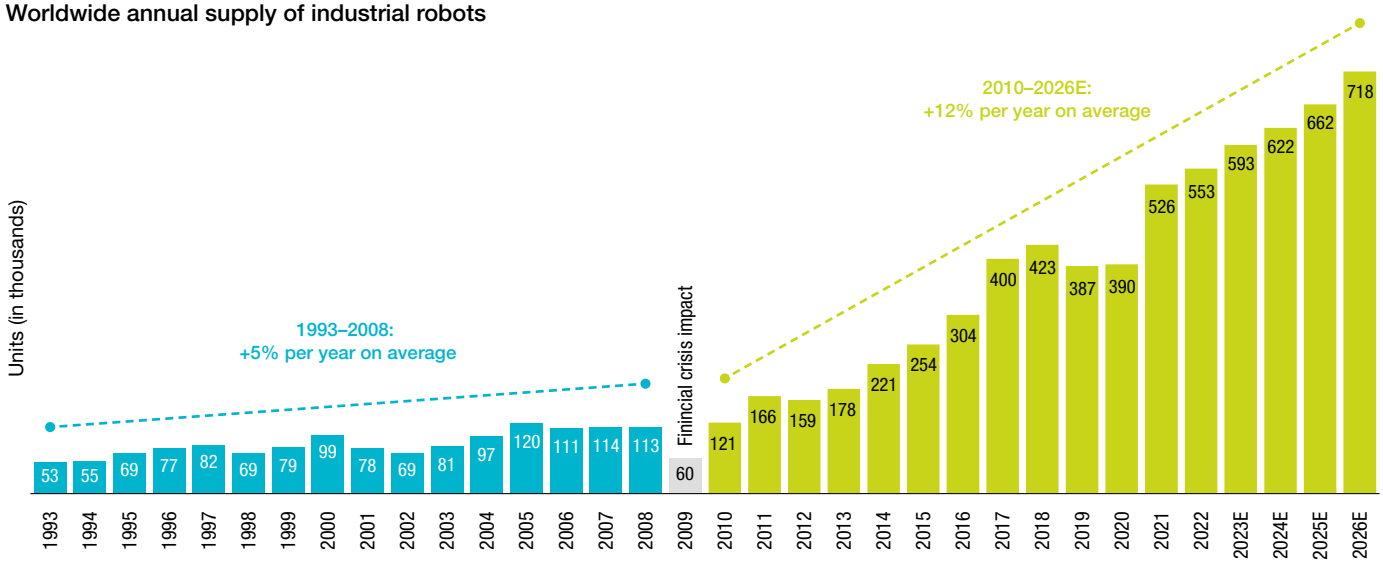
And when it comes to humanoid robots, after unveiling its first humanoid robot, Optimus, in 2022, Tesla now forecasts that several thousand Optimus robots will be working in its factories by 2025 with sales of Optimus Version 2 scheduled for external customers a year later. Elon Musk forecasts more than 1 billion humanoid robots will be in operation by 2040.

Taking a step back, for all this elaborate and enthusiastic talk surrounding AI, is it possible that could AI be hot air and mere hype? It wouldn't be the first time that the investment world has fallen for such hysteria. Addressing this, Osmani gives a different slant to such an idea.

"There is a debate on whether AI as a theme is overhyped, but we continue to see the implications of the advent of AI as being underestimated by the market in terms of potential market size, and in terms of speed of take-up," he says.

In short, the opportunities for investors are like AI itself, somewhat mind-boggling. And institutional investors have the intelligence to fully exploit those opportunities. It is therefore true to say there is nothing artificial about AI and robotic investment.

Worldwide annual supply of industrial robots



Source: Axa IM

GOODBYE TO LDI?

Two years on from the gilt crisis, it looks like the liability-matching market will never be the same again. *Chris Newlands* reports.

That fateful day back in September 2022 when the then prime minister Liz Truss and her chancellor Kwasi Kwarteng tried to push through £45bn of unfunded tax cuts created a series of catastrophic and unintended events.

The speed and the depth of the devastation was unprecedented and, in no particular order, Kwarteng was hauled home early from an IMF meeting in Washington and promptly sacked, the pound fell to its lowest ever level against the dollar, the Bank of England was backed into an emergency bond-buying programme, and Truss was forced to resign after just 45 days in office, making her the shortest-serving prime minister in British history.

The period was punctuated by one high-profile disaster after another but for a previously sleepy and lesser-known corner of financial markets it also caused no end of problems.

Indeed, almost overnight liability-driven investment (LDI), leaned on by corporate defined benefit (DB) pension schemes to help with asset-liability matching, went from a topic only covered in the pension and investment press to one that began making front page national news.

Kwarteng's mooted tax cuts, which included scrapping the top 45% rate of income tax, sent shockwaves through investment markets, resulting in plummeting gilt prices that pushed debt-fuelled LDI strategies to near-breaking point.

Amin Rajan, chief executive of Create Research, an asset management consultancy, says: "The mini-Budget was heroic in its naivety and catastrophic in its impact. At a stroke, it trashed national, pension and mortgage finances."

The dust has since settled but, almost exactly two years on, market participants remain divided over whether the underlying issues responsible for the difficulties have been fixed, with some adamant that significant hazards continue to lurk beneath the surface.

One thing they do agree on, however, is that the size, strength and trust in the LDI market will never be the same again.

Keeping it complex

So what exactly happened? In short, after gilt yields soared on the back of the mini-Budget, pension funds scrambled to sell

assets, particularly UK government bonds, in order to meet so-called margin calls on their LDI hedges.

Pension fund trustees fell over themselves to sell gilts in order to meet these collateral obligations, driving down the value of the bonds even further and creating what is dubbed a 'doom spiral'.

Without the Bank of England stepping in and propping up the market by buying bonds on an industrial scale the sell-off could have been fatal for great swathes of the country's defined benefit schemes.

Market experts say DB pension schemes were taken to the brink by their naivety, but that greed also played a part.

Indeed, when LDI was originally conceived more than 20 years ago the idea was to simply help pension schemes better match their assets and liabilities. As time progressed, however, strategies became more complex, with healthy doses of leverage added in to try and boost returns amid what was then a persistently low interest-rate environment.

The upshot is that what was once a simple and straightforward investment idea morphed into something that became increasingly harder for trustees to understand – so much so that the eventual crisis that took hold in 2022 came as a complete surprise for many, with little comprehension among pension funds as to how they got there.

John Ralfe, an independent pensions consultant, who was head of corporate finance at Boots when it switched from equites to bonds in 2000, says: "I would say that 99% of trustees had no clue what they were doing at the time and most investment consultants didn't know any better either. The leveraged LDI strategies being used when the crisis kicked in were far more complex and risky than people realised and were being touted.

"At some point in the early 2000s LDI went from something that was simple to something that was anything but."

It is unlikely that the LDI market will ever return to its previous value in terms of liabilities hedged.

Danielle Markham, Barnett Waddingham

Leverage, he adds, was layered on top of strategies to eke out returns at the same time as matching liabilities. Greed took over.

"Trustees were told back then that using leverage was the way to square the circle," he says. "People thought they could get something for nothing and that seemed to be the case as interest rates came down. But, when they rose sharply after the mini-Budget, problems quickly set in. The approach was marked by wilful ignorance."

Rajan agrees: "The asset fire-sale forced by margin calls was unprecedented in the pension world. Once again, the episode showed there are no sure-fire and risk-free strategies in investing."

Part of the problem, Ralfe continues, is the preponderance among investment consultants and asset managers to peddle convoluted financial instruments that make their high fees easier to defend.

"The market has been making hay from leveraged LDI strategies for a long time now. And the big investment consultants are especially to blame as they get paid for complexity," he says. "It seems to me that there is always some new sophisticated product that they are pushing. There is a lot more money to be made by keeping things complex rather than simple."

Getting jittery

In the immediate aftermath of the 2022 crisis, however, that ability to make money collapsed, at least in the short term.

As jitters set in, investors pulled billions of pounds from the biggest investment houses operating in this area in the days, weeks and months after gilt prices nosedived.

British fund manager Schroders lost more than £20bn of assets from the unit that housed its LDI business during the third quarter of that year, while investors pulled £19.7bn out of Legal & General Investment Management's (LGIM) UK DB Solutions business, the firm's liability-driven investment arm, during the first half of 2023.

Schroders and LGIM, alongside Insight Investment and Blackrock, are among a concentrated group of dominant players in the LDI market.

LGIM said at the time: "Our overall defined benefit revenue decreased as interest-rate rises caused assets under management to reduce and as clients sold higher fee-generating investments to meet collateral requests."

It added that the "extreme volatility" in the UK gilt market following the mini-Budget "highlighted the need for technical changes to ensure the smooth functioning of LDI and the government's financing of its debt".

Endgame

And it is not expected that those lost assets will come back at the rate the market once enjoyed. Not just because of what hap-

> **At some point in the early 2000s LDI went from something that was simple to something that was anything but.**
>
> John Ralfe, independent pensions consultant

pened in 2022, but due to the enormous volume of hedging that has already taken place.

Danielle Markham, head of LDI at Barnett Waddingham, an independent pension and investment consultancy, told *portfolio institutional*: "It is unlikely that the LDI market will ever return to its previous value in terms of liabilities hedged.

"During 2022 the value of UK DB liabilities fell significantly by 30% to 40% for many schemes [due to interest-rate movements] – and this means that the value of liabilities to hedge has also fallen sharply."

She adds that DB schemes have also reached a point where the vast majority of their liabilities are hedged, making it "inevitable that the market would stop growing at some point. As such it is unlikely that we will see a sudden increase in growth from here".

Evan Guppy, head of LDI at the Pension Protection Fund, the UK's £33bn lifeboat fund, agrees. "Our data shows that by April 2022, DB schemes had invested nearly 80% of assets in hedging instruments like bonds and annuities, up from around 45% 10 years previously.

"The big change in investment strategy towards liability hedging assets has already happened: meaning there simply isn't the same scale of unhedged liabilities left to manage.

"An additional and related headwind for LDI is that more schemes are now able to achieve a pension buy-out, and we are seeing an increasing number of schemes reaching their end-game with insurers."

In May, for example, the Nortel Networks UK Pension Plan completed its third and final buyout with Legal & General, with £2.5bn of the plan's liabilities now insured with the group. It is one of many such deals to be finalised.

Guppy adds: "All this means there is less new hedging needed by DB pension schemes while some of the existing hedging is being transferred to insurers."

A lack of focus

That may well be true, but the fact the LDI market had already grown so big is part of the problem, as that growth went largely unchecked. Getting a handle on the size of the market and just how many pension funds were using leveraged LDI was not clear and, according to a report from the Work and Pensions Committee written in the wake of the crisis, this was a key contributor to the mess.

The report also flagged that the Bank of England had already previously raised concerns about the rise of LDI but this had not been properly interrogated by the pensions watchdog, which the report referred to as a "missed opportunity to improve resilience".

The report read: "After the Bank of England spotted the potential risks of LDI use in 2018, The Pensions Regulator conducted a survey but neglected to look at small pension funds, which were the cause of the instability because of the nature of their arrangements. There was also no system put in place to collect data on how LDI was used. It was not known that leverage grew, giving rise to systemic risk."

The committee called for a more systematic collection of data and for regulators to work together to analyse those findings to spot emerging risks. It also said the Department for Work and Pensions should consider whether the use of LDI should be restricted while the process of improving standards of scheme governance takes place.

Sir Stephen Timms MP said at the time: "The turbulence around the mini-Budget exposed a lax approach to regulation. Despite the dangers of the use of LDI being identified more than five years ago, there was a lack of focus from the regulator and inadequate data. The use of leverage by DB pension funds grew, giving rise to systemic risk in a way that was not visible to regulators until the crisis hit.

"Although the speed and scale of the rise in gilt yields was unprecedented, the consequences for DB pension funds should have been foreseen and the regulator should not have been blindsided."

In fairness to The Pensions Regulator, it has done much to try and improve the resilience of LDI funds since the crisis, including increasing operational buffers to manage day-to-day volatility and working with overseas regulators to improve understanding of the risks, but much of the problem has been resolved by the fact that pension liabilities have decreased, meaning the need for LDI strategies is now not what it was.

Ralfe says in closing: "People were flying by the seats of their pants at the time. But has anything changed over the last two years? I'm not so sure."

DISCUSSION: FIXED INCOME

Fixed income is an important element of institutional portfolios, providing a regular stream of cash. But given the economic uncertainty, how are asset owners preparing these portfolios. *portfolio institutional* brought a group of experts together to find out.

We are living in interesting political and economic times.

Interest rates are high, growth in the West is low but inflation appears to be under control. We have a new government, but so could many other countries as more than 50 national elections are scheduled for this year.

So, what impact will all of this have on the debt markets?

"The first half of the year has been more challenging for fixed income markets than perhaps people thought," said Rickey Thevakarrunai, director of fixed income at bfinance.

The view coming into the year was of deep rate cuts and improved economic activity, however inflation has been stickier than hoped. "So fixed income has lagged behind the equity markets," he added.

But there is interest in these markets as "yields have drifted up", Thevakarrunai said.

Following the financial crisis, interest rates were at an historic low and yields were rock bottom. "You weren't getting a great deal from fixed income," he added.

But in the past two years interest rates have returned to pre-financial crisis levels. "Bond investors suffered the pain of 2022 and 2023, but it now looks more interesting given where yields are," Thevakarrunai said.

The return of yield is one of the big stories for fixed income this year, said Gurpreet Garewal, a macro strategist in fixed income and liquidity solutions at Goldman Sachs Asset Management. "It means bonds, once again, can deliver income," she added. "They can buffer portfolios from downside growth risks, and a higher yield buffer creates a higher bar for rate volatility to offset any income gains."

She points to positive fixed-income spreads in the first half of the year from corporate bonds, securitised credit and emerging market debt. "Even the frontier part of emerging markets has done well," she added.

New themes

Goldman Sachs has three key themes for this year. The first is navigating easing cycles. Then there is living with higher rates because if there is easing, we are not returning to the low-rate world of the last cycle. And the third is steering through new realities. On the easing theme, six G10 central banks have started cutting rates, including the European Central Bank and the Bank of England. "The pace, timeline and where those policy rates end up is divergent," Garewal said. "So that creates lots of interesting opportunities in interest rates."

Goldman Sachs likes Canadian rates due to dis-inflation, the labour market is loosening and, unlike the US, has no upside risk to inflation from tariffs later this year. "So there are lots of interesting opportunities under the hood," Garewal said.

The second theme of living with higher rates underscores the importance of bottom-up security selection.

"What is remarkable is that we have had a sharp rise in central bank policy rates and a series of shocks over the past few years," Garewal said, pointing to the gilts sell-off, geopolitical tensions and concerns about US commercial property. "Yet even with all of those headwinds, company balance sheets are remarkably resilient," she added.

> **"While credit spreads remain low at a headline level, under the hood there is a lot of dispersion.**
>
> Kunaal Vora, Railpen

So the capital markets have been wide open this year and a lot of companies have locked in low rates. "So on the whole, the private sector is in good shape," Garewal said. "Expansion in debt in this current cycle has been concentrated in the public sector and your active bond selection may need to find companies which can navigate this higher-rate regime." And in the final theme of new realities, the markets are being re-shaped by what Garewal calls the five Ds: digitisation, demographic ageing, destabilisation in geopolitics, deglobalisation in goods and labour, and decarbonisation. "We look for which companies and countries are on the right side of these trends," she added.

Decarbonisation is a theme that stands out for Jo Richardson, head of research at the Anthropocene Fixed Income Institute. She is looking into sustainability's impact on credit worthiness. And one of the conclusions of her research is: "More investors are looking to use their debt allocation decisions to promote their sustainability objectives," she said.

There are two drivers of such a strategy. One is that the more sustainable a company's operations are, the less it should pay for its debt funding. The other is that companies are starting to apply their engagement efforts beyond equities to include their fixed income portfolios in a bid to make all of their exposures sustainable.

Direction of travel

For Railpen, this is a year to reposition its fixed income portfolios, said Kunaal Vora, the scheme's head of external manager oversight. "It is fair to say that what investors were expecting at the start of the year has not materialised where six cuts were priced in, but now we are down to one, maybe two," Vora said. "So what this year has given us is the opportunity to build up our positioning in fixed income while rates remain quite high," he added.

THE PANEL

Huw Evans
Director
BESTrustees

Gurpreet Garewal
Macro strategist, fixed income and liquidity solutions
Goldman Sachs Asset Management

Jo Richardson
Head of research
Anthropocene Fixed Income Institute

Rickey Thevakarrunai
Director, fixed income
bfinance

Kunaal Vora
Head of external manager oversight
Railpen

Although Railpen is wary of duration and is on the shorter side of its intended allocation, the direction of travel is to increase its credit and duration exposures.

"That serves to diversify our book, but also gives us those starting yields and those prospective returns that we should be seeing long term from equity markets of close to 10% a year.

"So we have taken this opportunity to start building up our credit exposures," Vora said.

But for Huw Evans, a director at BESTrustees, scheme maturation is still a dominant theme among defined benefit schemes. "They are keen on contractual income, which points to fixed income assets," he said.

De-risking is another area of focus as many schemes are on the path to buying insurance policies, and so are interested in matching risk relative to annuity pricing.

For defined contribution schemes it is a little different, with a focus on their default funds and an interest in assets such as infrastructure debt.

Also conversations about decumulation are starting to happen in this space. "I am expecting to see some pretty creative solutions that allow investors to stay invested for longer rather than having to annuitise," Evans said.

A changing market

It appears that following the reset in yields, institutional investors are looking to allocate to safe fixed-income assets again.

"Before you had to reach further down the risk curve for that, but now we are seeing more clients allocate to European government bonds," Thevakarrunai said.

Before Covid, European sovereign debt yielded about 0.5%. Now they are over 3%. "So we are certainly seeing more demand for essentially safe yields, with clients not needing necessarily to take as much risk as in the past to generate a certain level of yield," he said.

The question is, do gilts offer a safe yield once again following 2022's mini budget, which resulted in a sell-off of Britain's sovereign debt?

Thevakarrunai described that event as a mixture of "reckless fiscal policy from the then government and a febrile view of inflation in the markets".

He added that the economic outlook has stabilised and the new government has been clear about not looking to spend too much, while yields look attractive again. "So it is certainly a safer haven," Thevakarrunai said. "If you look at Europe and how the bond markets reacted to the elections there, it looks a more stable place to invest than perhaps some other places."

But Garewal is not sure that gilts are a safe-haven asset, as investors have not flocked to the market with volatility appearing on the horizon. But she agrees that the asset class has a place in institutional portfolios given its higher yields. And that, in the near-term, gilts stand to benefit from further policy easing by the Bank of England.

Instead, the safe haven assets that are in demand are US treasuries along with perceived safe-haven currencies such as the US dollar, Japanese yen, Swiss franc and to an extent the German bund. "The widening we saw in France was not just

caused by French government bond yields rising; it was also driven by German bund yields falling," she said.

But Evans believes that defined benefit pension schemes are potentially overexposed to gilts, a sign perhaps that many are on the path to buying an insurance policy, and so are minimising their risk.

A lesson the liability-driven investment (LDI) crisis taught him was that when you are desperate to sell your long gilts, not many people want to buy them. "So gilts are not necessarily a safe asset," Evans said. "At some point, I anticipate needing to hand gilts over to an insurance company, which in general do not hold such assets and so will sell them more or less straight away. The Bank of England is also trying to sell them and so, with all that sales pressure, it is not necessarily going to be a particularly good asset to hold.

"The only reason I'm holding gilts is that it is the cheapest way to hedge out interest and inflation risk. I wouldn't hold gilts beyond that," he added.

Another asset owner using gilts to hedge its exposures is Railpen. "Given the repricing of gilts over the last few years, the hedges are effectively slightly cheaper," Vora said. "This has allowed us to hedge appropriately for certain schemes, apply some hedging to longer-term liabilities but given we are an open pension scheme, we remain committed to growth too.

> **"It is rare that our economists would be more constructive on AI than our bottom-up corporate analysts, but right now that is the case.**
>
> Gurpreet Garewal, Goldman Sachs Asset Management

"So in terms of an active allocation on the investment side, gilts are probably not what we are going to be using to express our duration views," he added. "But in terms of a long-term hedging exercise, gilts are a valuable tool."

So the expectation is that the gilt market will change. It has to. Evans believes that the debt management office understands that defined benefit schemes will no longer be a big buyer of these assets.

"There will be fewer super-long gilts and more of them will be designed to attract investors from a broader market," Evans said. "It will be quite interesting to watch."

Long-term green

Perhaps more of these bonds will be sustainable. Richardson is finalising her research into the relationship between climate commitments and performance on sovereign bond yields.

And it looks like there is a positive link between stronger climate commitments and tighter bond yields, controlling for credit factors.

"We are certainly hoping that with the new government, there will perhaps be a little bit more on the environmental side," she said.

"Hopefully, if there is a strong electoral performance, including in Scotland, the new government will feel more confident not to issue new oil and gas licenses. Transitioning to renewables can provide longer-term stability, which might be a driver of longer-term credit performance."

The previous government raised billions of pounds from issuing green bonds to fund projects designed to reduce carbon emissions in the country.

"We haven't seen any debt tied to longer term, more holistic KPIs, and that is often a good signal that people are prepared to make commitments longer than the electoral cycle."

Election year

The discussion then turned to this year's congested election calendar and how institutional investors are approaching the various outcomes.

"It is always an opportunity or a threat. Navigating that is going to be the challenge," Evans said.

"It is difficult to call," he added. "In the pension universe, I don't think we are going to see asset owners making big bets here. It will be more about ensuring that their portfolios are resilient to the geopolitical risks."

For Vora, markets tend to price-in elections quite well when they are far out in the future. France is an example of how calling a snap election can take markets by surprise.

"There could be some developments once these elections come to fruition in terms of where bond markets go and where risk markets go, but largely we see lower volatility from these election risks," he added.

Time for a cut?

And how are investors preparing themselves for potential cuts in interest rates?

"We could have answered this question last year and I could have said the same thing, and I would have been wrong, but for the next 12 months I might just be right," Vora said.

He added that the bias is there for a cutting cycle to begin as soon as September. The Bank of England, European Central Bank and Canada have already embarked on it, but the US is the big one. "It is not always that the US follows Europe, but the macro-economic variables this time around are slightly different, where a lot of the reasons for the cut bias are now due to disinflation," he said. "A lot of the inflation in Europe was due to an energy shock, whereas in the US it was animal spirits and strong consumers.

"What we are positioning for is that resiliency in portfolios that Huw mentioned. We see that the next 12 months are not going to be a one directional downward road to a path of least resistance to lower yields.

"There could be some bumps in the road along the way, and there is this talk of resurgent inflation leading to more hikes, but the political will and the will from central banks is for lower rates, and that is how we are trying to position in our portfolio."

So increasing Railpen's fixed-income exposures in the next year is on the agenda, and diversifying the sources of its contractual return away from equities is key. "We are moving away from growth markets to build portfolios that can withstand potential inflation hikes, geopolitical woes or election surprises," Vora said.

It's all about the Fed

Garewal agrees that the direction of travel for policy rates is lower. "It is remarkable that the UK has been the exception with headline inflation still above target in other major advanced economies but has been at target for a couple of months in the UK, while unemployment is below the natural rate."

So central banks are easing because what matters between now and the end of the year is what makes the Fed start its cutting cycle. Could that be the labour market starting to loosen or evidence that the US economy is weakening?

Those two outcomes will have different implications for fixed income. "In the former, you could see US treasuries do well, but you may also see fixed income spread sectors start to price in that cutting cycle," Garewal said.

"But if the Fed is cutting because of a more pronounced weakness in the economy, then of course you could see rates do better and perform their role as a hedge against downside growth risks. High yield and other cyclical parts of the market may prove less resilient."

When it comes to election uncertainty, there are still three months until the US goes to the polls. "A lot can happen between now and then," Garewal said.

"What is interesting about the UK election is that there has been little market response. Everybody is watchful of what happens with fiscal policy, what happens with supply-side reform, what happens with taxation. "We are in a wait and see mode, but I agree that fiscal prudence looks likely," she added.

Hitting the wall

Maturities and refinancings are important events in a fixed-income portfolio, but Railpen does not keep notes on them.

The portfolio is managed as a "multi-asset credit construct" which has regular maturities. "That way we are always aligning to the prevailing market rates and benefiting from the near-term yields that are on offer," Vora said.

> **"More investors are looking to use their debt allocation decisions to promote their sustainability objectives.**
>
> Jo Richardson, Anthropocene Fixed Income Institute

In terms of duration, Railpen's profile is around three years, which is in-line with the high-yield benchmark. "We are an open pension scheme, so our credit portfolios are return seeking in nature and diversify us away from equity risk," he said.

"So we look for managers to create alpha and to get into those areas of the market where we believe outperformance can occur."

Vora then turned to the "maturity walls" discussed in the financial press, which he admitted Railpen is mindful of. "Over the last few years, these maturity walls have dissipated quite quickly, with issuers tending to push the maturities out further," Vora said.

"That cliff edge has not been a factor for most investors. The important thing is the role of other sources of funding for a lot of these companies that have maturing debt, like private credit are coming into the market, which are alleviating some of the stress for the cohorts of credit which are struggling, or at the bottom end of credit quality.

"That is masking some of the default rates that we are seeing and masking some of the stress that we would tend to expect to see in credit spreads," he said.

Evans pointed out that refinancing does not only concern the assets a scheme owns, but also the covenants trustees rely on.

"So, if our sponsor is debt financed, we track when they are next due to roll over, and what is happening in the market around that time," he said.

"So far, so good. The debt walls have been well managed. They saw it coming and jumped in early.

"But at the same time, private credit managers are telling me this is a golden time for private credit. This makes me think that my private equity-owned sponsors are going to have to roll over their debt in a market where the lenders believe they are holding all the aces.

"So there are two sides to the refinancing coin," Evans said.

High risk, long duration

Sustainability could influence how much a corporate pays to be funded by debt when the loans in its fixed income portfolio start maturing.

"[Refinancing] is one of the key reasons why fixed income investors tend to have potentially more impact than equity investors," Richardson said.

"Companies are constantly coming back to market and asking for your money and basis points matter," she added. "You can negotiate covenants, make various commitments and engage on their strategic objectives and how they fit in with their transition plans.

"That is part of the core reason why we support a price-based fixed income engagement, where that discussion happens every year."

The other interesting point is that, in general, issuance is down because people are holding on for lower rates. This may have led to shorter maturities in those bonds that have been issued, however in some core transition-rich sectors, such as oil and gas, maturities have extended.

A lot of long-dated bonds have come out of the oil and gas sector. "It is easy for a benchmarked investor to buy everything and think it is okay, but within that you often surreptitiously extend duration to some of the sectors that might be of highest transition risk," Richardson said.

Good or bad?

Garewal pointed out that the volume of upcoming maturities is falling. She used US high yield as an example of where in the past three years maturities have shrank to $325bn (£253bn) from more than $840bn. "That speaks to the capital markets having been open and companies being able to refinance.

"They have broken down maturity walls, and remarkably, distressed issuers in the emerging market space have come back to capital markets for the first time in years," she added.

The headline default for US high yield and leveraged-credit market is just over 3%, which she says is in-line with the long-term average.

"But if you take out distressed exchanges, it falls to around 1.5%," Garewal added.

Distressed exchanges occur when a financially troubled company offers new debt, equity, or a mix of both, to creditors, typically at a reduced value to existing debt to prevent default. The question is, are distressed exchanges good or bad for investors?

"It depends," Garewal said.

While they result in losses for lenders, they are typically less costly and quicker than formal bankruptcy proceedings, and lead to more stable recovery rates. In some cases, the resulting capital structure proves to be sustainable; in others, it merely forestalls larger losses. As such, the impact on eventual losses from distressed exchanges remains uncertain.

"So, the big picture is that the credit fundamentals seem resilient, but there are a lot of things happening under the hood, which ultimately could support the importance of active management," Garewal said.

Vora is seeing similarities from 10 to 15 years ago when rates were low and zombie companies were muddling through. "You have little in public market scrutiny. The private nature of the agreed terms is giving companies who would once be classed as zombies, a bit more breathing room, a bit more maneuverability and the opportunity maybe for a private equity investor to come in and sweep them up."

He added that as we move towards lower rates, expect some of the pressures that these companies are feeling to alleviate. "You could be moving into a more normalised situation, rather than one of stress," Vora said.

Acid test

The extended maturities mean that defaults have been contained in recent years. Robust economic growth has been another factor.

"Earnings have been fine for the most part, so companies have been able to repay their debt," Thevakarrunai said.

Companies tapping more private sources of capital have also kept the default rate low. "Two years ago, if you said interest rates would go to 5%, many people would have expected a high default rate, particularly in high-yield markets, but that has not materialised as much as people expected," Thevakarrunai said.

He then pondered what has to happen in the economy to change that. "If it significantly weakens, there can be a potential for the default rate to pick up. But we haven't seen many managers put a significant spike of default rates in their outlook."

If the level of defaults rises, it could be a case of opportunity knocking for some investors.

"Throughout my career, default risk has been overpriced," Evans said. "So when I hear chat about default risk, my ears prick up and I start wondering whether there are opportunities.

"Right now the spreads are still quite mean, which maybe reflects demand. But if the market were worrying a bit more about default risk, I would be looking for opportunities rather than thinking this is going to be a problem. Of course, the acid test of your fixed income manager is how many defaults they experience relative to the market as a whole," he added.

When talk of defaults pick up, there tends to be more dispersion within markets. "And more dispersion should be a valuable source of returns for your active manager," Vora said, who added that Railpen works with managers to take advantage of such opportunities. "We expect our managers to pick credits in this environment and do well with their own proprietary research, rather than what ratings would suggest.

"While credit spreads remain low at a headline level, under the hood there is a lot of dispersion. You are also seeing a bit of a bifurcated market in terms of quality when it comes to the lower rated issuers versus the BB and above cohort," Vora said.

Emerging assets

The conversation then turned back towards ESG and sustainability. Railpen's strategy here leans towards engagement. "Divestment, whilst offering a market signal, doesn't achieve much in terms of change," Vora said.

"We prefer to engage and use our clout as large investors in equities and debt to try and influence companies," he added. For example, Railpen is allocating assets to an energy-transition portfolio, which, it is hoped, will give it a say in how the bigger energy companies operate. "We believe we get the best from companies – and can influence them most effectively – when we actively engage with them on ESG issues."

This reflects what Thevakarrunai is seeing. He said that more than 80% of institutional investors across the world demand that their managers demonstrate ESG integration in their debt

portfolios. "They want to see a clear ESG process," he added.

The good news is that more debt specifically labelled green, social or sustainable is being issued to fund certain projects, which are typically focused on the energy transition.

Garewal predicts that we could potentially see $1trn (£778bn) worth of issuance of such debt this year, after almost $500bn hit the market in the first half – 11% of the investment-grade market equivalent.

With eight emerging countries believed to be responsible for almost half of all climate-harming gas emissions, there is a major need for transition funding in these economies.

Much of the green, social and sustainable bond market will be green. Goldman Sachs has looked into green bonds issued by emerging market sovereigns and companies.

There is a strong case for allocating capital towards emerging markets for sustainable development, Garewal said. Such economies are home to more than 80% of the world's population and are responsible for approximately three quarters of global carbon emissions. "To put it simply, you cannot have a global energy transition without the active participation of emerging markets," she added.

> **"We haven't seen many managers put a significant spike of default rates in their outlook.**
>
> Rickey Thevakarrunai, bfinance

Yet only a fraction of the $2.5trn (£1.9trn) globally sitting in sustainable or ESG funds finds its way to the emerging world. "That needs to increase," Garewal said, adding that the benefits for investors are higher yields thanks to inefficiencies in the market and high economic growth.

She added that more emerging market sovereigns and corporates are starting to issue debt and tapping into global appetite for sustainable bonds can diversify their funding. If companies and sovereigns can show their commitment to making their operations more sustainable it could open the door to funding global private investors, or public funding from the EU and the IMF. However, she warned that despite improvements, there are still questions over the standards of transparency and reporting, especially on how the proceeds of the bond are invested.

Regime shift

Evans then highlighted a big issue for trustees in their approach to building sustainable portfolios.

He said that 95% of the time trustees allocate to responsible investment and ESG is spent generating compliance documents, such as implementation statements and TCFD reporting.

"We have next to no bandwidth for the discussion that has just taken place," he said.

"From a trustee perspective, we all want to make the world a better place, and we will be all over it if the risk-reward is appropriate, but we are not going much deeper into it."

Richardson added that with sustainability increasingly being seen as a driver of returns will change that. "The more that some of the externalities come into pricing, the more there are valuation shocks, the more your asset managers may come and talk to you, then maybe it can get up the agenda."

The good news is that green bonds can offer a spread over conventional bonds of the same credit risk in some instances, according to Garewal. "So, even investing with sustainability in mind is primarily about the risk-adjusted return potential, but with the added benefit of contributing to sustainability objectives," she added.

Another issue is that a lot of the sustainable impacts are going to be realised over the next 10 to 15 years. "So it is hard to price in a lot of the positive externalities today. But governance concerns have always been a key consideration, especially when investing in emerging markets where weak governance can contribute to default outcomes. This holds true, to some extent, among developed market sovereigns and corporates as well.

Richardson and her colleagues spend a lot of time identifying unpriced externalities. "We all agree that over 20 years they are going to be in," she said. "It doesn't need many of them to come through to suddenly refocus minds.

"I believe we are on the brink of a valuation regime shift in that more of these things will be priced into markets, and there will be a re-adjustment of thinking," she added.

One area where Richardson has completed a lot of research is oil and gas where she found that bond spread curves over 10 and 30 years are invariant to production changes.

Some companies predict a reduction in production, while others, some of whom are A-rated, are forecasting increasing their operations. "A 30-year investment in a company which is predicting a $68 price and planning unconventional production, is a bad credit investment. At some point, we will realise that."

An artificial approach

A new innovation that is expected to change many areas of our world is artificial intelligence (AI). But what impact is it having on fixed income investing?

Goldman Sachs is looking at generative AI from the perspective of how the technology can enable business growth and enhance client experience, improve developer productivity and increase operating efficiency across all parts of the firm. Garewal explained that human-like outputs and the ability of generative AI tools to produce novel outputs for generalised uses are what distinguishes generative AI from previous AI tools. "You don't need to have a PhD in computer science to interact with them," Garewal said. "They have a usable interface.

"The first two of these traits increase the use cases, and the last one will increase adoption," she added.

Goldman Sachs' economists believe this will influence the economic outlook within five to 10 years. "Economics is often considered to be a dismal science," she added. "It is rare that our economists would be more constructive on AI than our bottom-up corporate analysts, but right now that is the case. The difference in view lies in the time horizon in question; economists are thinking about the potential long-term boost to productivity and growth, while corporate analysts are assessing the near-term impact on company revenues."

> **"Throughout my career, default risk has been overpriced.**
>
> Huw Evans, BESTrustees

AI tools have the capabilities to optimise investment research and analysis as well as improving the efficiency of tasks such as compiling legal documents. "It has the potential to increase the breadth of investment ideas and will hopefully improve your information ratio, but there will always be a human in the loop," Garewal said.

It is unclear at this stage if generative AI will grow revenue or if it is just about cost efficiency. Is it truly going to lead to more productive activities? "That remains to be seen," Garewal said.

T-bill and chill

The final theme of our roundtable discussion concerned the outlook of the asset class.

Thevakarrunai homed in on credit spreads, believing that they should remain relatively stable in the next 12 months.

"None of the managers we speak to are predicting huge credit narrowing or widening," he added. "Low default rates, the ability to refinance and a more benign economic outlook with moderated inflation, mean that credit spreads are going to be relatively range bound, certainly in the investment grade and high-yield markets."

Thevakarrunai then explained that one of the big themes in the next 12 months within fixed income will be when to extend duration. He pointed to the US saying: "T-bill and chill" – just invest in a money market fund and earn 5%.

"So why would you need to move out of the curve and take further risk," Thevakarrunai said.

What typically happens when central banks start cutting and the curves normalise, is that people potentially look to lock in yields further along the curve.

"So it would be interesting if we see a movement out of shorter-dated fixed income into intermediate and longer-maturity markets. That will be key over the next 12 months," Thevakarrunai said.

Earning and spending

Government expenditure could be another key theme that drives yield curves steeper, but perhaps is one that we will see in the longer term. "Generally, when we see yield curves getting steeper, credit spreads behave themselves a lot better," Vora said. "That is a function of investors moving into credit and lending to corporates rather than to governments. It also indicates an economy that is moving along nicely – generally a positive for corporate health."

Living in a higher for longer environment will be another issue. "Even as we settle to a lower interest rate than we are now, it is going to be higher than what we have seen in the last maybe 15 or 20 years since the financial crisis," Vora said.

"As that culminates in more defaults, more distress and some companies hitting the wall, you are likely to see a big discernment in terms of credit performance. And that dispersion, that ability for a manager to actively select credits, is going to be paramount for investors."

Garewal picked up on navigating the higher for longer theme. Certain households have savings buffers and locked in low mortgage rates, while corporate balance sheets are healthy. "But now we are at a point, in the US at least, where the labour market has returned to where it was pre-pandemic. So any further loosening could lead to weakening.

"As long as consumers are employed and earning, they are spending, but that could change over the next six to nine months. What will be key to assess is to what extent Fed easing will help to elongate that cycle.

"So, the importance of active bottom-up security selection may become increasingly more important," she added.

Richardson then put deforestation on people's radar. Thinking about investor impact on our climate has broadened out to more of a focus on nature. Regulators are taking more notice of the impact of corporate behaviour on the natural world. Indeed, the EU is implementing regulation that means products sold in the bloc need to be deforestation free.

Similar laws could soon arrive in the UK and the US, she said. "Supply chains that are in scopes 1 and 2 are incredibly opaque, disparate, not tracked and have multiple layers of indirect suppliers. This will have a significant cost if it is not priced in.

"A lot of investors increasingly are looking at deforestation as an entry level nature-based sustainability theme," she added.

Evans ended the discussion by saying that for pension funds, all eyes will be on the new government. "The question will be, is it going to do anything that disrupts the megatrends?"

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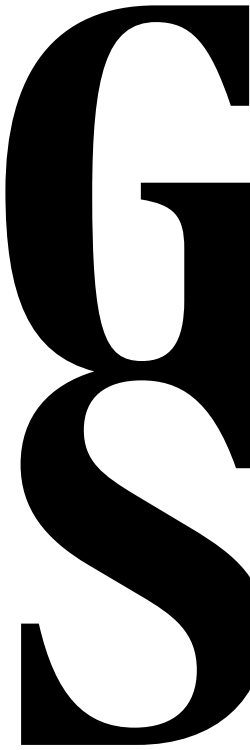

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Far from allowing polluters to continue polluting, carbon capture and storage technologies help to keep climate change in check. Yet, as this month's ESG Club explains, a lot of work is needed before it makes a real impact.

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PROXY VOTING 2024 – ASSET MANAGERS PULL BACK ON SOME RESOLUTIONS

Support for environmental and social issues fell in this shareholder voting year, but governance proposals received a boost. *Andrew Holt* investigates.

Proxy voting on environmental and social resolutions this year has proved a sticky issue, at least for some asset managers.

Firstly, looking at the broader voting trends, 2024 has been something of an interesting year for ESG-related votes.

Governance proposals gained greater support, but for the environmental and social segments, it is complicated, said Lindsey Stewart, director of stewardship research and policy at Morningstar Sustainalytics.

Stewart identified ESG shareholder resolutions are still growing in number, but for the first time, the growth is primarily driven by 'anti-ESG' proponents.

There has though been a rebound in support for governance-focused proposals, from 30% in 2023 proxy year to 35% this year. Resolutions seeking to bolster shareholder rights enjoyed particular success.

Highlighting the reason behind this approach, Blackrock revealed in its Global Voting Spotlight: "In the 2023-24 proxy year, investors – including Blackrock – supported more shareholder proposals addressing corporate governance issues than in previous years. Generally, these proposals focused on introducing provisions to further strengthen the rights of minority shareholders, such as Blackrock's clients."

Blackrock's support for all shareholder resolutions rose slightly to 11% in the 2023 proxy year, from 9% last year.

There has though, overall, been a decline in shareholder support for environmental and social resolutions, which continued in 2024.

Average support for E&S resolutions fell to 16% this year from 19% in the 2023 proxy year.

Underlying shareholder backing for key E&S resolutions, those supported by at least 40% of a company's independent shareholders, remained at 2023 levels despite the continuing broader decline.

Large asset managers appear to have continued their withdrawal of support for E&S proposals in 2024, according to Morningstar, driving growth in a cohort of 'near miss' resolutions with between 30% and 40% independent shareholder support.

Continued growth in the overall volume of resolutions with falling average support is likely to prompt questions about the quality of proposals being filed, as well as the future of the entire shareholder resolution process, from institutional investors and companies.

One way to look at what has happened is to suggest that the largest asset managers appear to have continued a trend to rein in their support for some ESG-related resolutions.

Overly prescriptive

Asset management behemoth Blackrock came in for some stick after its Global Voting Spotlight revealed that it only supported around 4% of the shareholder proposals it voted on in the proxy year to the end of June, compared with around 7% in 2023 and 22% in 2022.

In the spotlight, Blackrock highlighted its approach: "Like last year, investors found the majority of these proposals [focused on climate and natural capital risks] to be overly prescriptive, lacking economic merit, or asking companies to address material risks they are already managing. As a result, these proposals continued to receive low support from shareholders, including Blackrock."

But Felix Nagrawala, financial sector research manager at responsible investment campaign group Share Action, is not impressed. "Blackrock's voting record this year is disappointing but not unexpected. Our research has shown Blackrock has repeatedly been one of the worst performers in recent years and seen its support of resolutions plummet."

And he added: "While they say the resolutions are too prescriptive and lack merit, in reality, we found most resolutions – three quarters in 2023 – were just asking for more disclosure – hardly too much to ask for companies when it comes to systemic risks like climate change that is in the long-term interests of its clients."

No support

Another big asset manager, Vanguard, surprised many with its announcement that it supported no shareholder resolutions on E&S themes.

"Vanguard's announcement that it supported precisely zero shareholder resolutions on environmental and social themes in the 2024 proxy year is certainly striking, but it doesn't surprise those of us who have been watching asset managers' voting patterns closely," said Morningstar's Lindsey Stewart.

Stewart then tried to be put the proxy-voting trend, at least among the bigger assets managers, in a wider context.

"Amid ongoing pushback on all things ESG from more conservative elements of the political spectrum, Blackrock, Vanguard and other large asset management firms have increasingly emphasised a focus on financial materiality and traditional corporate governance," he said.

"This emphasis has manifested in recent proxy voting decisions that dissent from company boards' recommendations with increasing rarity, meaning much lower support for shareholder proposals," Stewart added.

ESG INTERVIEW – FAITH WARD

"Recognising that you cannot save the world is important."

The chief responsible investment officer at Brunel Pension Partnership tells *Andrew Holt* about looking at the big picture, being focused on real world change and dealing with everything, everywhere all at once.

Could you give me an insight into your approach to responsible investment?

Our thinking starts top down. We think about the systemic issues that are affecting the economy and society and what those implications might be for our investment portfolio and the associated financial risks. So we start with that big picture.

Addressing those risks can present investment opportunities. What we try to do is make sure we are aware of them, assess them and take action where possible.

Our strategy has three pillars: integration, collaboration and transparency.

The bulk of the detailed work is with the asset managers – we focus on setting expectations rather than being overly prescriptive. Being 100% outsourced, that is our primary business model.

It is then how we integrate responsible investment into the decisions we make, in terms of asset manager expectations and what we do on voting and engagement policies, bringing together the integration and collaboration approaches and then finally, communicate it, which is the transparency.

So those three lenses – how we integrate it, who we work with and how to report it – is a matrix of how we bring this approach to life.

Has there been any disconnect between your responsible investment policies and what asset managers are delivering?

Asset managers have timelines and mandates that are constructed in a way that are different to pension funds. We try to bridge that by setting our expectations when we have a mandate.

Sometimes it is co-created, where we work closely with the managers. This is essential when we are taking on the challenge to integrate climate into an asset class that hasn't traditionally had that. Our net-zero multi-asset credit portfolio is a good example of this, and the work is on-going. But yes, we do read about those who do not come up to the bar. And in terms of expectations, the bar is getting higher. But there is only so much time and energy we have to bring firms up and there comes a point where you may need a new manager.

For listed equity the bar is quite high and last year we led the work looking at voting on what the differences were on oil and gas companies, post the Paris Agreement. UK asset owners were driving that, but there was evidence that with asset managers, especially the larger ones, the alignment is limited and has diminished in some instances in recent years. From the other point of view, asset managers have also said they want asset owners to be more explicit about their expectations by setting parameters.

It is a difficult line to draw when you are trying to be clear about the outcome you are seeking and the expectations on risk management. We have done some work on bridging the gap by communicating

what we expect any manager holding high-impact companies to provide. We need that level of granularity to provide us with evidential-based analysis of the risks around climate and any individual company and its actions to address them.

You have described Brunel as being focused on a 'real world' approach to responsible investment. What does that mean?

There are two tactics when approaching climate risk: one is to avoid the problem, the other is to change the situation by providing a solution to make progress. So what we mean by 'real world' impact is getting stuck into the difficult things is the more appropriate strategy and will deliver the impact in the real world we seek. It means pivoting to transition finance, doing the complicated stuff, not just investing in deep green. We need to work with the trickier parts of the economy. It is picking out the more difficult sectors and companies to focus on.

We try to pivot towards the real world. That is why our approach to divestment is more nuanced. It is about thinking through the outcome we are trying to achieve and what are the best mechanisms to achieve it.

So divestment is the option of last resort?

That is how I have always categorised it. Divestment, or using investment exclusions, is an appropriate strategy where normal stewardship tools are unlikely to provide the desired outcome.

Although in the coming years, I think we will become more nuanced to when is the right time to move away from certain sectors and activities.

Could you summarise the key findings of your latest *Climate Progress* report?

It covered Task Force on Climate-Related Financial Disclosures (TCFD). It also covered our other climate and ESG-related challenges.

In short, we either progressed or achieved all of the targets we set ourselves. We have made our net-zero commitment by 2050, but we are looking for pretty material progress by 2030.

We were also able to report a reduction in our carbon intensity of over 50% from our baseline in 2019. Although this is not a fantastic measure, it is useful to give some reduction direction to our portfolios and the wider market. We have reduced that by 50%. We have also reduced our exposure to the fossil fuel sector by just shy of 90% since 2019.

Presumably meeting those targets is why you extended your reporting beyond the TCFD's requirements.

We have met many of them. The one area where we need to progress, particularly in the product area, is some of the forward-looking metrics in our scenario analysis. That is because we are still trying to navigate what is being used. We are transparent on all of the metrics.

Could you tell me more about your net-zero ambitions?

It is to be net zero by 2050 and operationally everything we invest in needs to be aligned by 2040. In other words, we need a clear plan as to how these are going to be decarbonised by then. So plenty of progress by 2030, but by 2040 we should have a solid plan.

In your *Responsible Investment & Stewardship Outcomes* report you highlighted how Brunel wishes to raise the bar on impactful stewardship. Why has that become more important?

Within stewardship there has undoubtedly been a lot of progress. The big change is looking at how efficient and effective stewardship has been.

What we are trying to say is we need to be much more focused on the outcomes we are trying to achieve. There have to be consequences to stewardship, otherwise it is not going to make any difference. It is

a recognition that we have not always been as effective as we would have liked to be in corporate engagements.

You have voted against companies that have not come up to scratch on ESG. Is that an important part of your armory?

It is, and it is an area we have stepped up on. Voting, as a signal, is part of our armory. It is a way of reinforcing those engagement conversations. It is a way of proving the changes we want to see.

We have stepped up our voting. It has been enabled by artificial intelligence, which has allowed us to process more information at a quicker rate and give us greater confidence to take action.

Do you see any scepticism among your partner funds in addressing responsible investment?

I wouldn't say scepticism. They get involved in setting our stewardship and voting policies. So there is a lot of engagement, although there is sometimes a difference of opinion.

Where some of the challenges come is on the question of: are we having enough impact? Are we seeing the changes? In some instances we are not. So that is a fair challenge.

So it is about doing more and being assertive. Where we have faced scepticism, that has helped us put our case better. The majority of partners support the work Brunel is doing.

What are the biggest challenges you face from a responsible investment perspective?

You feel like you have to deal with everything, everywhere, all at once. There are an awful lot of challenges. What we have achieved is a much higher awareness of the risk. The awareness is so much higher. The expectation from society is you then have to solve all of these problems.

Recognising that you cannot save the world is important. But going forward we need a concentrated effort in some areas where we can progress smartly. One example is Mining 2030, led by the Church of England Pension Fund, which comes at the problem in a different way. We need to solve this for a range of responsible investment reasons, not just for climate. That takes a lot of effort. But that is how to bring about real change.

Do you expect a different approach to ESG from the Labour government?

The Conservatives had good moments: they set the legally-binding net-zero target, Boris Johnson was good in the run up to COP26 and there was good momentum. So the Conservatives started strongly, but it was more the retrenching when things got a little bit tricky.

Equally, the Labour government has come out of the gate strongly. We have the National Wealth Fund, which we have been advising on. They also have commitments to net zero as part of the Transition Plan Taskforce. We are keen to go forward with that, and a commitment to the green taxonomy – initiatives that stalled under the previous administration.

But it is all about resolve and sticking with these strategies. Only time will tell if Labour has the courage of their convictions.

What we mean by 'real world' impact is getting stuck into the difficult things.

There has been a push back on ESG in some circles: is this an issue in your view?

It has been through a bit more of a rocky patch in the last couple of years. There has been a bit of a reality check.

The act of being challenged will make us, as a wider group of responsible investors, much better and stronger and help us improve through better communication and articulation on the issue.

We need to keep pushing though. The rollback on the FCA's listing rules is disturbing. If it leads to a race to the bottom, it will be counterproductive.

We need to keep fighting and articulate our case.

But if you look at the momentum going into COP26 in 2021, it was positive. Overall, we are in a much more positive place than we were many years ago, when many didn't see responsible investment as a relevant financial issue.

What about the role of supranational bodies and government in addressing climate change and ESG issues?

We do need that ambition from such organisations. We have seen some positive changes. And we need that as a great deal of harmonisation is needed, in carbon markets and the like, in order to make change happen on a wider scale.

We need to bring about change as a global community. There is still a lot of fiscal adaptation and resilience that needs to be baked in and this is massively under actioned.

What are your responsible investment ambitions for Brunel?

It is having that impact. It is about seeing the desired outcomes actually delivered.

What has been the biggest lesson you have learnt from your career?

I am continually learning. Therefore, I have learnt that it is important to build a strong network of people who know what they are talking about and to regularly tap into that.

INVESTING WITH CARE: THE KEY TO RESILIENT RETURNS IN THE UK CARE SECTOR

Over the coming decades, the UK care sector will become all the more critical. Demographic trends are placing ever-greater demands on an already ageing care system. Investment is needed now to meet the needs of the future.

Institutional investors and managers can work together to help transform care infrastructure in the UK. But it is important that this happens in the right way to deliver good outcomes.

How can investors build care home portfolios with resilient returns?

The answer is a quality-first approach.

The needs of the care system and investors are aligned

The UK needs more quality care homes.

"Over the next century, we're set to see almost 300% growth in the over 85 cohort of the population," said Mike Toft, who is head of care homes at Octopus Real Estate.

It's not just the number of care homes, but the quality of care that can be provided.

"While there is a balance of care beds now, over the long term, we're going to see a reduction in quality care beds being provided in the UK. There's a big obsolescence issue underlying the provision of stock.

"Around 50% of care homes in the UK were registered more than 20 years ago. These are often Victorian conversions, which lack ensuite wet rooms, suffer from inefficient design, and have poor ESG credentials.

"Because of the age of the infrastructure, the ability for operators to provide the highest quality of care is becoming increasingly difficult. And we're seeing some operators deciding to close care homes."

There is a clear opportunity for private capital to build and operate care homes that are fit for the future. And focusing on quality is aligned with the needs of investors as well as customers.

Targeting resilient income

"It's ultimately about the quality of care being provided to the elderly cohorts. That's fundamental to what we're doing.

"Because we believe that focusing on quality of care from an investment strategy perspective leads to a more resilient income profile."

A state-of-the-art home with the highest quality of care should ensure demand is strong and beds are full. That obviously translates into a more robust and predictable return. What's good for residents – the best care possible – is also good for investors.

Mike's view on the link between the quality of care homes and the quality of investment performance was only reinforced during the global pandemic. As a whole, the care sector performed well during a challenging period. However, it did draw attention to the clear advantages of fit-for-purpose homes.

"Covid-19 highlighted the difficulty some operators had to overcome in providing quality care in ageing homes compared to the homes we are investing in. Having those ensuite wet rooms, wider corridors, and the ease of segregation made an enormous difference."

Looking ahead to the future, as newly developed care homes become more energy efficient, we'll see the resilience of returns only strengthen.

"We've seen a multiplication in the energy costs operators are bearing. In some cases, there is as much as a 300% increase in utility costs. Modern care homes are more able to mitigate that cost pressure, whether that's the introduction of PV panels or heat pumps over time."

Our strategy

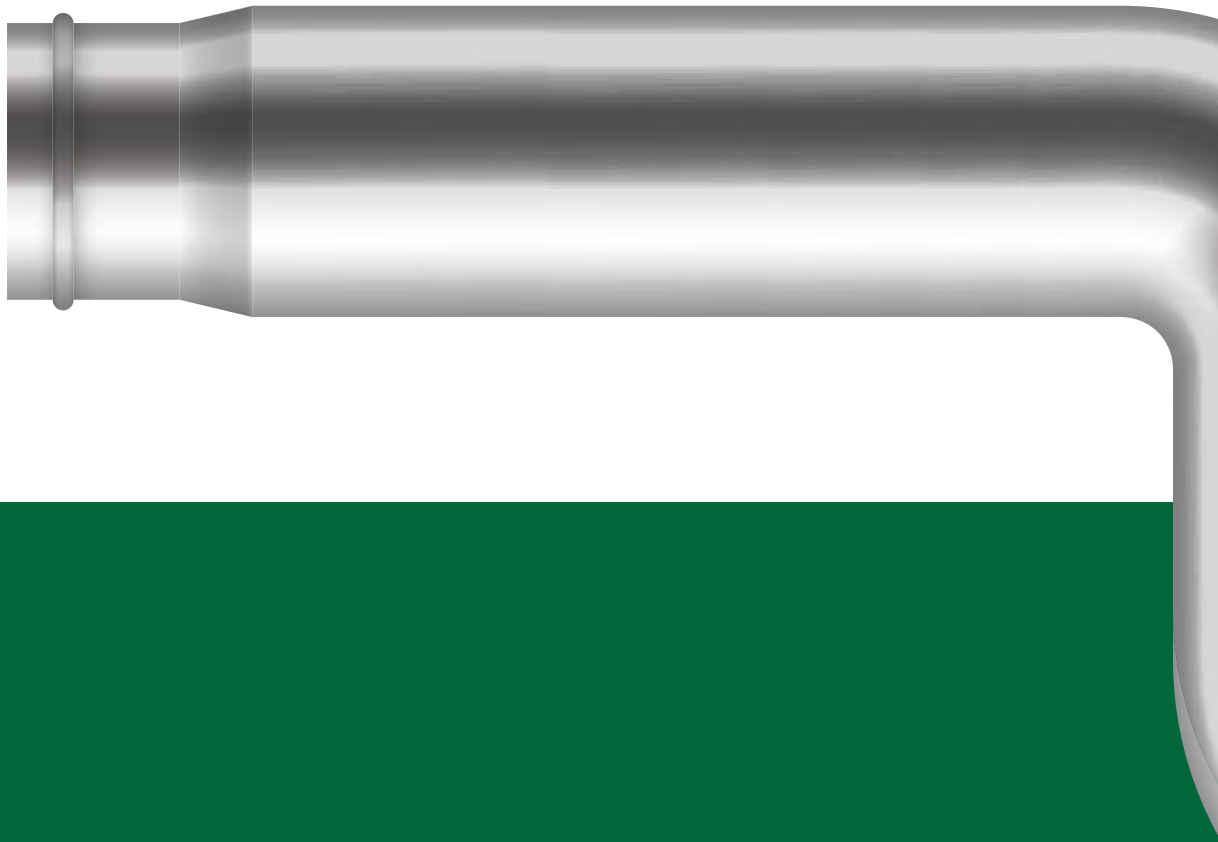
"What we're doing with our current strategy is targeting long-term, countercyclical returns for our investors and meeting the growing demand for quality care homes.

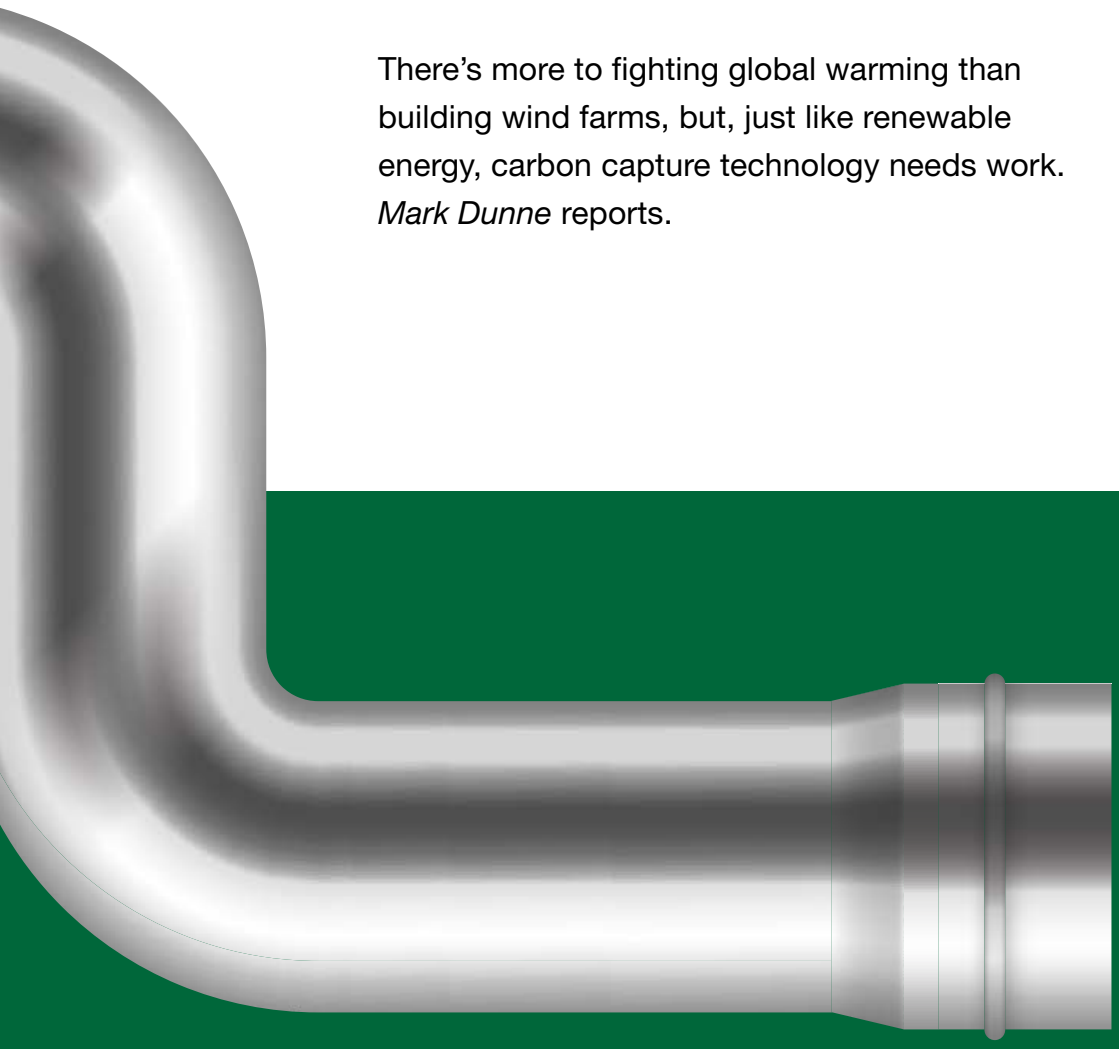
"Investing in the right locations, with operators capable of providing the highest quality of care, should lead to a resilient investment and allows us to build a more sustainable care sector.

"We have a clinical assurance team, which is the cornerstone of the underwriting process. With highly experienced nurses in the team, we have eyes and ears on the ground. They're liaising with the operators, liaising with their clinical leads, underwriting the clinical frameworks which operators have in place, and liaising with the regulator. That sets us up for success."

"Fundamentally, what we're doing is investing in care homes that we would be happy for our own loved ones to live in. Having homes that are fit for the future will ensure the right quality of care is provided."

CLIMATE CHANGE:





There's more to fighting global warming than building wind farms, but, just like renewable energy, carbon capture technology needs work. *Mark Dunne* reports.

PIPE DREAM

It sounds like the Saudi oil minister's wet dream: burning oil and gas to power parts of the economy, while still being on a path to limit global temperature rises to 1.5-degrees.

Science is making this a reality. Indeed, carbon capture and storage (CCS) technologies are designed to complement the natural carbon sinks that remove the climate-harming gas from our atmosphere.

The idea is that carbon dioxide (CO_2) is sucked out of the atmosphere and is then imprisoned underground instead of hanging in the air and stopping heat from escaping into space.

Such innovations are needed given the abundance of climate-harming gases in the skies above us. Indeed, 27 CO_2 appraisal and storage licences have been approved in the UK so far.

However, such approaches to help the world reduce the level of climate-harming CO_2 in the atmosphere are proving to be controversial.

For some, it could be seen as an excuse to not invest in renewable forms of energy and therefore to continue using fossil fuels, which could save oil companies from extinction. For others, the efficacy of such technology is unproven.

Yet such innovations are needed to clean up the world's energy system. In the UK, for example, an average of almost 20 million tons of carbon dioxide needs to be cut each year until 2030 to meet its carbon commitments.

With the country so reliant on fossil fuels, it is not going to be easy to make such a drastic reduction each year. And there are always going to be some areas of the economy that you cannot decarbonise.

"We call it net zero for a reason," says Nick Stansbury, head of climate solutions at Legal & General Investment Management (LGIM), acknowledging that completely removing carbon from our economies will be difficult.

Steel, cement, chemicals and aviation are industries that will be hard to entirely decarbonise. The food on our plate is another problem.

"However much we work at dietary change, we are going to struggle to remove all emissions from the agricultural system," Stansbury says.

> **We must never hold up CCS as a reason not to decarbonise.**
>
> Nick Stansbury, Legal & General Investment Management

Then there are what Stansbury describes as "fugitive emissions" from municipal waste and landfill sites. "There are always going to be some quantum of harmful emissions in the system," he adds.

Yet there are scenarios which could see the world completely abate all harmful emissions, Stansbury believes. But they involve "incredibly aggressive" policy action. "Our view is that those are relatively unlikely scenarios, so there is an important role for the 'net' in net zero," he says.

Burying the problem

It is clear that developing more reliable cleaner sources of energy, changing how we produce food and dispose of waste in a way that is kinder to the climate will not be enough to help us achieve net zero in the next 25 years.

We have to deal with the emissions which cannot be prevented. Then there is the carbon that is already in the atmosphere, which could, scientists say, remain in the skies above our heads for up to a thousand years.

So there is a need for carbon sequestration, storage and removal. There are three approaches here, which are either natural or technical.

First, there is nature-based carbon removal. This means trees, peat bogs, seagrass, fungi, soil and the oceans, which are all carbon sinks. As trees grow, for example, they capture carbon from the atmosphere and store it.

But the issue is that trees are not a permanent store of Co_2, in that carbon is released when they are cut down and burnt for fuel or warmth.

So this is a matter of preserving existing carbon sinks and creating new ones, such as through planting new forests.

Category two is geotechnical carbon storage, which is sucking carbon dioxide out of the atmosphere, also known as DAC. The captured carbon is then pressurised until it turns to liquid and is injected into permanent geological storage. This typically means porous rocks or depleted oil and gas reservoirs.

Confidence in the permanence of this method has been borne from a long track record of success. "If hydrocarbons formed over millions of years in a reservoir, we can be confident that any CO_2 we put in do not leak out. If it could, it is highly unlikely that the hydrocarbons would have formed there in the first place," Stansbury says.

The third method is carbon capture and storage (CCS). Rather than sucking CO_2 from the air, gases are captured at the point of emission – a dream come true for the Saudi oil minister.

"It is stopping emissions at the source," Stansbury says. "It is not about undoing the harm of emissions which previously took place."

The emissions are then liquefied and injected into the ground and capped off to keep them there. "We still produce CO_2, but

> **CCS has an important role to play, but it isn't a golden bullet.**
>
> Nick Stansbury, Legal & General Investment Management

rather than allowing it to enter the atmosphere, we store it," Stansbury says.

Part of CCS is bioenergy carbon capture and storage, which is known as BECCS. Stansbury describes this as key if we are to reach net zero. "In many scenarios, it is thought to have the potential to play quite an important role," he adds.

But the process is controversial. As a route to generating net-negative emissions "BECCS is a provocative subject that will raise heated opinions from different people", Stansbury says.

Indeed, a study by Imperial College has highlighted the problems with such technologies.

The study labelled the goal to scale up carbon capture and storage technology to remove up to 30 gigatonnes of CO_2 each year by 2050 as "overly ambitious".

It said that storing up to 6 gigatonnes of carbon underground each year by the halfway point of the century is more feasible. It could even rise to 16 gigatonnes if storage capacity increases, which will need much more investment into the sector.

If such an option is to make a positive impact on decarbonising our economies it needs to up its game.

To achieve net zero, the International Energy Agency estimates that around 1 billion tonnes of carbon dioxide will need to be captured and stored globally each year.

Globally, about 51 million tonnes of carbon dioxide was removed from the atmosphere last year, according to BloombergNEF, which was only 0.14% of such emissions.

No golden bullet

So will CCS have a dominant role to play in meeting net zero?

"No, we don't think so," Stansbury says.

"It has an important role to play, but we don't see a world in which we continue to burn the same quantity of fossil fuels as we do today and then simply capture the CO_2 and store it in the ground," he adds.

Economics is one reason. The cost of generating power from renewable sources, such as wind and solar, in most parts of the world has fallen to a level that makes it cost efficient to replace large parts of our fossil-fuel infrastructure with low-carbon alternatives. "That would be cheaper than relying substantially on CCS in the power system," Stansbury says.

So is CCS not the game changer it appears to be on paper?

"CCS has an important role to play, but it isn't a golden bullet," Stansbury says. "It isn't as though if we get CCS right then nothing else has to change."

In fact, one of LGIM's catchphrases here is "and not or". "The challenge of reaching net zero requires us to say "and" an awful lot, and it doesn't require us using "or" very much.

"It isn't a case of using CCS or renewables or afforestation or hydrogen or nuclear," Stansbury says. "It is a case of utilising all of the renewables, CCS, nuclear and hydrogen that we can.

"We need every one of these tools, and we need to use as many of them as we can manage if we want to stand a good chance of getting anywhere close to net zero by 2050," Stansbury says. "We just need to keep saying, 'and', 'and', 'and', 'and'.

"We need all of these tools. It is not a case of if you support CCS, you are not supportive of renewables. They are both important," he adds.

That is not to say LGIM is being unrealistic about the problems and uncertainties that come with CCS. "We must never hold up CCS as a reason not to decarbonise," Stansbury says. "It should never be looked at as something that we use instead of abating emissions.

"It is something we use alongside doing as much abatement as we can possibly get our hands on. That is why we find this 'and not or' framing helpful.

"None of these technologies allows us not to use the other one," Stansbury says.

Here to stay

Time is running out as we march towards 2050, a year where most companies have set their net-zero deadline. "The only way of getting there is to use every tool that we have in the toolkit, and to use as much of them as we can possibly get our hands on as quickly as possible. And even then, it's going to be incredibly challenging."

Sir John Armitt, chair of the National Infrastructure Commission, was quoted by *The Financial Times* as saying: "We don't live in a perfect world and there is always going to be some carbon to be captured from different processes to enable particularly heavy industry to do what it needs to do."

So it is clear that renewable energy alone cannot fully decarbonise the economy.

Companies should focus all their energy on abating their emissions, but also developing CCS systems.

It's not quite a strategy that will put a smile on the face of the Saudi oil minister or allow polluters to ignore their greenhouse gas emissions, but it is an acknowledgment that fossil fuels are unlikely to be eradicated for generations to come.

DECONSTRUCTING THE CULT OF CRYPTO

With investments in digital currencies breaking records could they be heading to an institutional portfolio near you? *Andrew Holt* reports.

Crypto has been something of a cult investment. Believers are committed to it, unreservedly, like any good cult members should, propagating its freedom and how crypto can break state monopolisation of the financial sector. Non-believers, however, have generally stayed away, not wanting to be burned by its unpredictably.

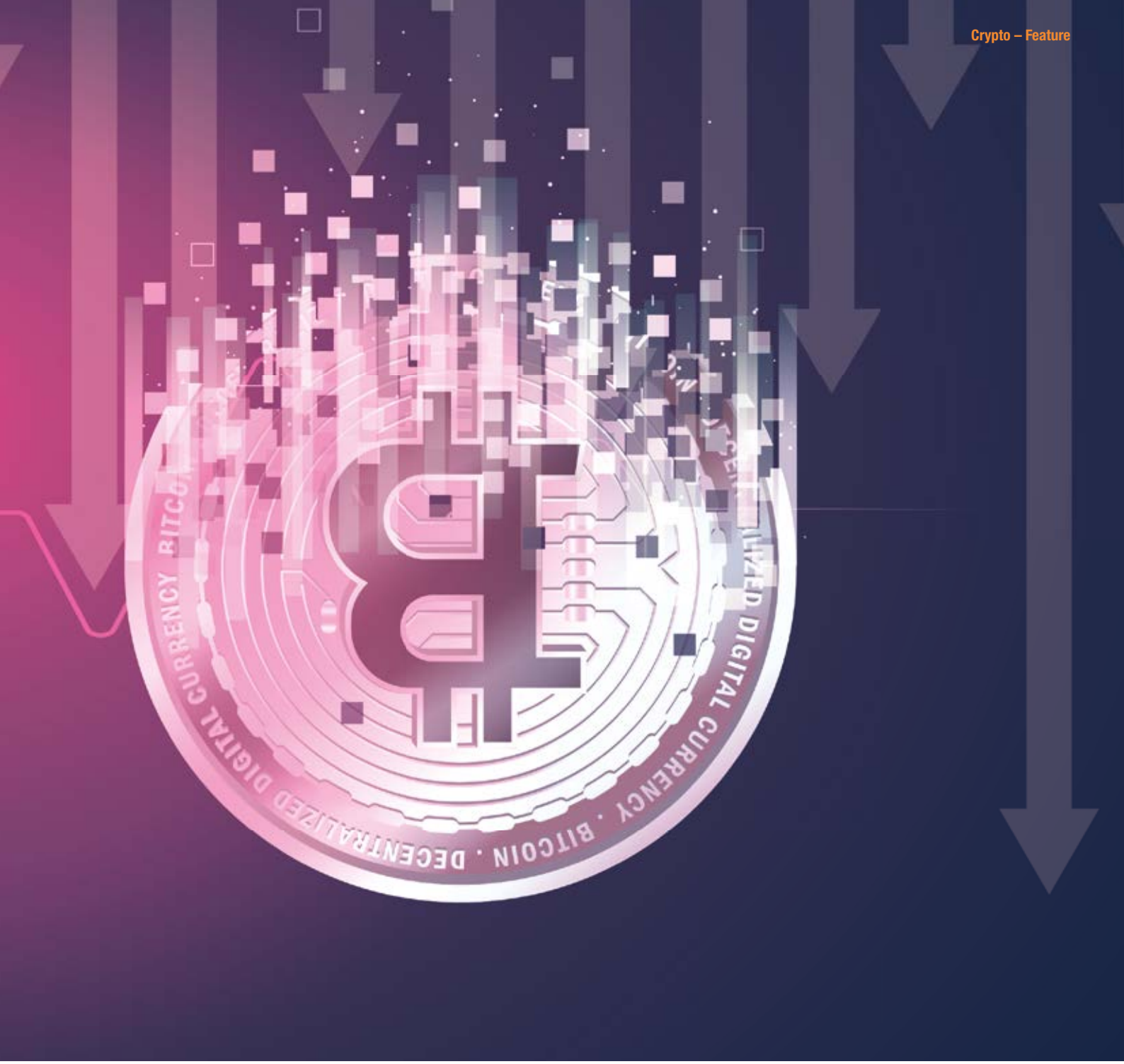
Yet is there a case for presenting it as a valid form of institutional investment? Its evolution has been the complete reversal of the normal development of an investable asset class.

Usually investments begin at an institutional lab, fulfilling some institutional portfolio need, and gradually feeds through and down to the retail sector. However, crypto has been created from the opposite end of this spectrum, emerging and evolving as a form of retail investment, and expanding out from there.

Matteo Dante Perruccio , senior adviser at 3iQ Capital Management, homes in on the evolution of crypto. "If you think of any other investment innovation, whether that be derivatives or hedge funds, they generally came to a more sophisticated investor base and then made their way down and were simplified for the retail investor," he said.

In addition, that retail focus brought with it numerous challenges. "When an investment is on a retail level it receives a lot more visibility and coverage, which has happened to crypto," Perruccio says.

Advocates of crypto say the market is now highly developed, offering institutional investors opportunities in which to invest, if chosen carefully. There is no doubt that there are different ways to invest in crypto.



Rise of the crypto ETF

Crypto exchange-traded funds (ETFs) are one such avenue. ETFs are predicted to transform the crypto investment market, becoming an important part of pension fund investments. In fact, blockchain expert Fiorenzo Manganiello sticks his neck out by predicting that crypto could form 5% of pension fund portfolios by the end of next year.

There is no doubt that crypto has momentum behind it, especially via this ETF route. One example is the report in the *Financial Times* that Blackrock's spot bitcoin ETF has accumulated $16.7bn (£12.8bn) of assets since it launched in January, suggesting a great deal of investor interest.

And this looks set to be the start. More and more crypto ETFs are due to enter the market, with 'Ether ETFs' gaining full and final approval from the US' Securities and Exchange Commission (SEC) over the summer.

Manganiello therefore believes regulatory greenlights such as this will play an important role for more institutional investors, such as pension funds, to view crypto as a greater viable investment asset.

For Manganiello, it's only a matter of time until these institutional players muscle into the crypto market. "Crypto ETFs have been given the regulatory green light and, for an asset that has long been considered volatile and novel, it's a big step.

"Crypto is beginning to prove the critics wrong, it's been given regulatory legitimacy," he says.

He also gives a nod to its retail history. "I won't deny that crypto has traditionally been seen as a retail market. But, with Black-

rock stepping in and growing its own spot ETF so quickly, it won't be long until other institutions take the leap and invest in crypto. The Ether ETF approval will only be a catalyst."

Put it in your pension

Expanding out on this positive outlook Manganiello looks at the crypto investment case. "Crypto can be highly profitable – and institutional investors will definitely look to take advantage of it as they seek to diversify their assets," he says. "That's why by the end of next year we'll see crypto ETFs form a decent chunk – at least 5% – of pension fund portfolios."

That seems a decent jump, especially from what is a standing start. And with various numbers being bandied around, I put the institutional investor interest in crypto to the test by enquiring with some UK pension fund holdings of crypto. I found a regular response: nothing to see here. This does suggest that the noise surrounding crypto could still be noise, at least for a key part of the institutional investment world.

Based on that, on what grounds has Manganiello concluded that pension funds are set to embrace crypto? "We have seen a huge movement from institutional money into this space," he says. "At the end of the day, it's incredibly important for institutional investors to stay ahead of the curve. They have to adopt what I'd call a 'millennial savviness', an approach that embraces emerging, innovative alternative investments – and isn't bogged down with preserving the status quo," he says.

"With crypto, it is no different, institutional investors have to be ready to consider crypto as an asset – and especially with crypto ETFs quickly gaining approval," he adds.

Although the investment numbers in crypto cited thus far look impressive, Manganiello notes that about a fifth of money flowing into crypto ETFs is from institutional investors, so there is room for a great deal of improvement from an institutional investor perspective.

Scratching the surface

ETFs are not the only route to crypto for institutional investors. "There are a variety of ways in which to engage with and get exposure to digital assets," says Dovile Silenskyte, director of digital assets research at Wisdom Tree.

"As investors have shown interest in investing in crypto assets, ETPs (exchange-traded products) represent a good route-to-market option allowing for convenient and safe access to this asset class," she added.

There are other benefits of ETPs that offer an appealing route to institutional investors, Silenskyte says. "Most crypto-asset ETPs give investors institutional-grade trading and custody services, addressing investor concerns such as hacking or theft of the private keys, or not being able to access liquidity across various crypto exchanges," she adds.

"Most importantly, crypto ETPs can seamlessly plug in to existing trading and brokerage platforms," Silenskyte says.

Institutional investors can now access crypto ETPs via some of Europe's most popular exchanges including the London Stock Exchange, SIX [the Swiss Exchange], Börse Xetra [the German electronic exchange] and Euronext in Amsterdam and Paris.

One such market debut is particularly important, Silenskyte says. "The London Stock Exchange listings is a significant step forward in the legitimisation and relevance of the asset class for UK professional investors."

There is genuine context to that statement. The launch of US spot bitcoin exchange-traded funds in January has been the most successful ETF launch ever. "We could be scratching the surface when thinking about their growth potential after such an impressive start," Silenskyte says.

An historical year

These are therefore defining times for crypto. "2024 has been historical for crypto currencies," Silenskyte says.

Supporting the successful crypto narrative Perruccio adds: "Crypto is the best performing asset in 2024."

This is borne out by investor interest. Investor appetite has increased this year, demonstrated by net inflows across crypto ETPs, for example, of nearly $20bn (£15.3bn) globally in the year-to-date. Since the start of the year, assets in crypto ETPs have trebled from a little over $30bn (£23bn) to more than $90bn (£69bn) due to these flows and overall market moves.

It does seem crypto is breaking records in all areas which could be used as evidence of how popular and important it is becoming amongst investors, or, for those with good memories, it could have worrying comparisons to the tech boom-and-bust of the early 2000s.

Crypto is the future of institutional investing. Therefore, can institutional investors not afford to be invested in the future?

Matteo Dante Perruccio, 3iQ Capital Management

> **Crypto is beginning to prove the critics wrong, it's been given regulatory legitimacy.**
>
> Fiorenzo Manganiello, LAIN Group

Whichever scenario you think is the most accurate, there is no doubt that the digital assets ecosystem continues to grow and diversify, which creates new opportunities that may be of interest to investors. "It boils down to asset allocation and risk management frameworks to determine which levels of involvement are warranted in a broad portfolio context, but we believe digital asset have a place in most portfolios, even if in small amounts," Silenskyte says.

As crypto is such a young asset class and because many investors are still relatively unfamiliar with it, it would be easy to think that the neutral positioning is 0% investment and that anything above zero is overweight. But this, Silenskyte says, is not the case.

"A good assessment of the neutral positioning of an asset in a multi-asset portfolio is to look at the market portfolio, that is the portfolio that simulates the totality of all listed, investable assets access," she says.

The total market cap of listed, investable assets sits at around $200trn (£153.6trn), so is substantial. With a market cap of more than $2trn (£1.5trn), crypto represents just 1% of that. This market is now of a similar size to high-yield bonds, inflation-linked bonds or emerging markets small caps.

Volatile market

The neutral position therefore for multi-asset portfolio managers is to invest around 1% of their portfolio assets in bitcoin and/or other crypto. "1% is the rational choice for investors in the absence of a strong, supported investment thesis against crypto assets: for example, if portfolio managers decide not to invest in European equities, they usually have clear reasoning for such decisions," Silenskyte says.

And looking at it further within a portfolio, Silenskyte adds: "It has been shown that integrating crypto into diversified multi-asset portfolios offers potential benefits in enhancing the risk-return profile of those portfolios."

Indeed, the big concern about crypto is its volatility. Responding to this, Perruccio puts forward a defence. "In any asset allocation there has to be a risk-return profile. And volatility in of itself is not a bad thing," he says. "It is only a bad thing if the return doesn't justify it. The volatility in crypto can be a nice return enhancer. Where else are you going to get that?"

And another hurdle crypto has to overcome, thanks in part to its retail history, is the perception as something that works on a more trading level than as an investment. But there are traditional investment attractions for institutional investors. "You can buy and hold, you don't need to trade," Perruccio says. "People do focus on the volatility of crypto, but if you look at its performance year-on-year you will have done pretty well indeed."

So what should the investor exposure be? "There are different types of exposure," Perruccio says. "If you put in 3% or 4% of digital assets in your portfolio you can increase the Sharpe ratio pretty significantly. It wouldn't be a core holding. Investors should be looking at 3% to 5% in large-cap crypto. It can sit alongside equities," he says.

Large-cap crypto is usually defined as having a market cap of more than $10bn (£7.6bn), so pretty substantial.

This size of market cap stands out for two reasons, Manganiello says: they are considered to be safer investments because they have more liquidity and therefore can better withstand market volatility. And two, they tend to have a history of growth, vitally important for investors.

Perrucio also makes the point that crypto should be seen in a greater historical context, in terms of the development of other investments. "In the early days of emerging markets, institutional investors would never contemplate 15% to 20% of their portfolio in emerging markets. It was 1% to 3%. That has since changed."

Will investors therefore follow the emerging market trend and increase their allocation to crypto? "Possibly, who knows," Perruccio says, giving an indication of the uncertainty of how the market, and investors approaching it, will or will not address crypto. But there is another reason for institutional investors to consider crypto. "If institutions only invested in the big guys and more established stuff they would significantly underperform a lot of the market," Perruccio says.

"It is a case of coming out of your comfort zone and looking at the opportunity of crypto," he adds. "So what I would say to institutional investor chief investment officers is learn about it. There is a lot of peripheral noise, it is young, but it is here to stay."

Perruccio concludes on a positive note, saying that the future looks bright for the asset class. "Crypto is the future of institutional investing. Therefore, can institutional investors not afford to be invested in the future?"

THE FINAL COUNTDOWN

$1.5trn

The commercial real estate debt pile that is set to mature before the end of 2025.

Source: CBRE

20%

The expected decline in the value of the defined benefit de-risking market this year to £40bn from the record £50bn set in 2023.

Source: Standard Life

£45bn

The aggregate surplus enjoyed by the local government pension scheme in England and Wales in June, giving them a 112% funding position, up from 110% in May.

Source: Isio

£40bn

The projected additional investment capacity created by combining local government pension schemes into a single national fund.

Source: Pension Insurance Corporation

£1m

The potential price of gold per kilo by the early 2050s, if it continues to grow at an average of 10% per annum against the pound, as it has since 2000.

Source: Tally Money

€20.9bn

The estimated inflows into ETFs in Europe during July, more than half of which was for equities (€11.2bn), taking the total assets under management to a record €1.85trn.

Source: London Stock Exchange Group

$36.5bn

The estimated investment in emerging market securities during July.

Source: The Institute of International Finance

5.2%

The performance of the FTSE All Share in the first half of the year, despite the economic uncertainty.

Source: Bloomberg

€42.6bn

The inflows into Europe-domiciled fixed income funds during July, it's strongest month for more than five years and more than four times the investment into equity strategies.

Source: Morningstar

Quote of the Month

"Recognising that you cannot save the world is important."

Faith Ward, chief responsible investment officer at Brunel Pension Partnership

The AMNT

The AMNT provides support, guidance and a collective voice to member nominated trustees, directors and representatives of private and public pension schemes. Together, the AMNT enables you to make a greater and more active contribution to scheme governance.
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