PORTFOLIO INSTITUTIONAL MARCH 2025

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MEGATRENDS: A NEW PATH FOR INSURERS

2050
Year zero

DIVERSIFICATION
Going global

NEST AND IFM
The art of the deal

Issue No. 141 | www.portfolio-institutional.co.uk | Independent analysis for institutional investors

MEGATRENDS: A NEW PATH FOR INSURERS

Ethel Caterham has celebrated more birthdays than anyone living in Britain today – 115 of them, in fact. But what's more surprising than Ethel's age is that she is one of almost 15,000 Brits alive today to have hit treble figures. And the number of centenarians in the UK has doubled since 2002.

But while the average life expectancy is rising, birth rates have slumped to a record low. So not only is the number of retirees rising, but there will be fewer working-age people to fund them.

This is just one structural change which is re-shaping the economy and creating new risks for long-term investors but also offers investment opportunities.

The impact of climate change, the need to power our economies by renewable rather than extractive sources of energy and the changing geopolitical landscape are other examples of megatrends that are changing how we live our lives.

Our cover story this month looks at how insurers are adapting their investment portfolios to match such long-term structural changes. Read our take from page 16.

This edition also looks at how long Donald Trump's election will continue to boost US stocks (p24), if the government's push to get pension schemes to invest more in the UK will produce better outcomes for savers (p38) and with the backlash against ESG, how can pension schemes build a winning net-zero strategy (p34).

We also speak with Nest's investment chief Liz Fernando (p12), who explains why the master trust has taken a stake in Aussie investment manager IFM, while Brightwell's Emma Douglas talks about all things sustainable (p30).

We hope you enjoy this edition.

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IN THIS ISSUE

BIG IN JAPAN

There are strong arguments for looking at Japan's equity markets. *Andrew Holt* reports.

Japan's equity markets are looking promising this year. Some estimates suggest corporate earnings are forecast to rise another 9.1% in 2025, on the back of a 7.9% jump in 2024.

Further profit growth for Japanese prime market companies is therefore expected as the domestic economic recovery continues with the value of stocks likely to rise as profits climb.

Asset Management One is bullish. The asset manager expects the TOPIX index to reach 3,000 by the end of this year, up from 2,736 at the time of writing. And the forward price-to-earnings ratio of the TOPIX is expected to be 14x in the first half of 2025.

Asset Management One believes rising profitability will be driven by four factors.

One, a transition from a deflationary to a growth economy.

Two, progress in management reforms focused on capital costs and likely to boost share prices.

Three, the increasing strategic importance of Japan to the US under President Trump. And four, a revitalisation through the government policy of "nation of asset management" – where the authorities want to promote the development of the asset management industry.

Importance of corporate governance

In addition, and on the second point listed, progress on management reforms focused on capital costs and likely to boost share prices, has come into sharper focus from Tokyo Stock Exchange (TSE) research, which suggests businesses that have improved their corporate governance have outperformed.

Companies in the prime market that responded to the reforms saw an average share price increase of 28% during the previous 18 months versus 14% for companies that did not.

Companies that were chosen as good examples of the reforms saw their share price rise by an average of 50% in the same period – a substantial fillip.

The TSE is urging companies to put in place in-depth plans to improve return on investment rather than just introduce temporary measures like share buybacks.

And the increased investor enthusiasm for Japanese equities is driven partly by corporates shifting their focus towards improving their share price performance.

Kazuhiko Hosaka, senior product specialist at Asset Management One, said: "Corporate reforms are becoming increasingly popular amongst businesses, and investors are continuing to benefit from what are expected to be significant share buyback activity.

"Firms are taking significant steps to focus more on enhancing their capital efficiency and share price performance – a great sign for overseas investors in the Japanese market," he added.

Stability and resilience

Asset manager behemoth JP Morgan has also stated Japan is its preferred investment market for 2025, citing its macro-economic stability and resilience amidst global trade uncertainties.

The asset manager lists six reasons behind this outlook.

One is that Japan remains a top investment destination due to its macro-economic stability, mild inflation and resilience amid global trade uncertainties.

Two, Japanese equities are expected to deliver "low-teens" returns, supported by projected earnings growth of 9% in 2025 and the already cited significant structural reforms like improved corporate governance.

Three, the US-Japan trade relationship remains "stable", but global trade uncertainty poses risks, particularly through potential spillover effects on Japan's export-dependent economy.

Four, Japan's tourism sector has rebounded strongly post-pandemic, contributing 7.5% to GDP and boosting employment and real estate markets.

Five, wage growth and inflation have created a "virtuous" cycle, with real wage growth turning positive, but productivity improvements needed for sustained economic expansion.

And six, Japanese equities remain undervalued compared to global peers like the S&P 500, offering attractive opportunities for "under-invested" domestic and international investors.

Tariff threats

Although there are challenges ahead, with one big question surrounding how Japan's equity market and economy responds to threats of tariffs from the US.

Japan's share of US imports has been low in recent years, at less than 5%. However, the impact of tariff hikes on the car industry have been cited as a cause for concern. Cars are Japan's top export to the US and are often transferred there through countries which may see higher tariff rates, such as Mexico, forcing costs to rise steeply.

Then there is the issue of inflation, which in Japan is rooted at 2% in the medium to long term. It is therefore possible for long-term interest rates to rise by around 2% to 3%.

It should be noted that The Bank of Japan is pursuing a policy of gradual monetary policy normalisation, with no immediate rush for rate hikes despite domestic and international pressures.

But even considering the impact of "quantitative tightening", the rise in long-term interest rates is, according to many commentators, expected to remain relatively unchanged for the time being.

THE UK GROWTH PROBLEM

The economic picture is full of issues that are problematic for investors.

The chancellor of the exchequer Rachel Reeves has put much store in her growth plans, which have been promoted as a key government economic policy.

But these plans have seriously hit the rocks leaving a confused picture for investors in the process. Lacklustre business sentiment suggests that a much lower figure is likely, with the Bank of England revising down its real GDP growth forecast for this year to 0.75% from its previous estimate of 1.5%.

This doesn't bode well for Reeves.

All eyes will now be on the Office for Budget Responsibility's (OBR) release of its updated economic and fiscal forecasts on 26 March. The OBR's fiscal outlook plays a crucial role in shaping government's policies and could have a negative impact on the gilt market.

For investors that could be a case of déjà vu, with the aftermath of then chancellor Kwasi Kwarteng's mini Budget in September 2022 causing mayhem in the gilt market.

Although there are no expectations for things to get that bad: at least not yet.

"We could see a bumpy time in the gilt market in the run up to the OBR's latest assessment of the last budget on 26 March," said Daniel Casali, chief investment strategist at boutique asset manager Evelyn Partners.

But should the UK's growth outlook be revised down then the expected fiscal position would also weaken.

To complicate matters, the chancellor's self-imposed fiscal rules require that the Budget of day-to-day spending, excluding capital expenditure, to be balanced by 2029/2030 and for the targeted net financial liabilities ratio – a broader measure of public debt – to decline by the same year. This constrains any government movement.

There is therefore limited fiscal headroom of just £10bn to meet the balanced budget rule – a key marker for maintaining the government's fiscal credibility with financial markets.

However, meeting this rule will largely be dependent on the growth outlook.

Fiscal gap

Asset manager JP Morgan estimates that if the OBR cuts its near-term growth forecast by 0.5% for 2024-25 and 2025-26, while keeping an optimistic average growth of 1.7% onwards, it will cost around £17bn. But if growth in the later years is revised down the fiscal gap could double.

The government also faces other headwinds to meeting its fiscal targets. These include the higher cost of borrowing.

Overall, JP Morgan estimates that if the government wants to deal with the expected shortfall and leave fiscal headroom of £10bn, it will probably need to find savings of around £20bn in the Spring.

Politically, raising taxes may not be an option for the chancellor, as it would go against the Labour Party's manifesto.

Reeves and the Labour Party have committed to boosting economic growth through infrastructure investment, planning reforms and decentralisation efforts – with institutional investors expected to play a central role.

It remains to be seen whether the chancellor's proposals to scrap regulatory red tape to drive construction will boost investment, and with it the country's growth.

Inevitably UK equities could come under some strain within this testing growth scenario – although not all.

"Despite the country's economic challenges, large cap listed companies benefit more from global growth, as UK multi-nationals generate a significant proportion of their revenues from overseas," Casali said.

In addition, geopolitical disruptions, such as restrictions on energy supplies, could lead to outperformance in value-focused sectors like energy, where the UK stock market has significant exposure.

In contrast, by setting self-imposed fiscal rules and setting out an ambitious growth agenda, the government has created a stress point in the gilt market – always a worrying area for investors and governments alike.

"Should the government be seen to be missing its fiscal rules, it is possible that longer-dated gilt yields could rise to reflect doubts over its fiscal credibility, particularly with foreign investors," Casali added. "That's because given that the UK reports a twin Budget and current account deficit, it is heavily dependent on the willingness of foreigners to buy gilts."

In the last 10 years, foreign purchases of UK debt, mainly gilts, have been largely behind the positive net portfolio inflows. Without these foreign savings, the sterling exchange rate would probably be a lot lower.

However, some good news for gilt investors is that the UK's fiscal challenges and gilt supply issues are well known, while weak growth and moderating inflation, albeit with some upward pressure from energy and regulated price changes, could encourage lower yields.

Meanwhile, demand for short and medium-term gilts could see a boost if the Bank of England cuts the base rate.

The interest-rate environment is also markedly different. With US inflation slowing, the Federal Reserve is cutting interest rates, which puts less downward pressure against sterling.

"In short, provided inflation does not make a material comeback, gilts could offer some portfolio protection in the event of a recession," Casali added.

PEOPLE MOVES

We start this month's round-up of the latest recruitment news in the institutional investing space at **Pension Insurance Corporation**. The insurer of defined benefit pension liabilities has started its search for a new chief executive after **Tracy Blackwell** decided to retire after almost 20 years with the firm.

Blackwell has spent the past decade in the boss' chair but started at the insurer on day one in 2006 as chief investment officer.

Meanwhile, infrastructure investor **GLIL**, which is backed by six local government pension schemes, is looking for a new managing director after **Ted Frith** quit.

Frith (*pictured*), who was also chief operating officer, is moving to international infrastructure investor **Equitix**, which has \$14bn (£11.2bn) worth of assets under management.

Also looking to fill a soon-to-be empty seat at the boardroom table is **The Pensions Regulator**.

The Department for Work and Pensions has started the search for a new chair of the pensions watchdog after **Sarah Smart** decided to step down.

Smart (*pictured*) is to leave the regulator in July after spending the past nine years on the board, initially as a senior independent director.

Professional trustee specialist **Aretas Trustees** has appointed **Antony Miller** as a partner and chair.

He was a founder of 20-20 Trustees and spent almost 11 years as executive director before leaving in December 2023. He started his new role in early February.

Finally, **Pi Partnership** has strengthened its governance services offering after it made two appointments to its trustee executive services team.

Hosung Jeon and **Laura Johns** have joined as a scheme secretary and as a senior consultant, respectively.

CALENDAR

Topics for upcoming *portfolio institutional* events*

05 March 2025

Private Markets Club Conference

01 October 2025

ESG Club Conference

*Subject to change

NOTICEBOARD

The UK's largest master trust by assets under management intends to invest £5bn in illiquid assets during the next five years after buying a stake in an Australian pension scheme-backed asset manager.

Nest is to take a 10% stake in **IFM Investors**, joining 16 superannuation funds on the company's shareholder list.

The deal is part of the £48bn master trust's plan to boost its allocation to private markets from 17% of assets under management to 30% (read more on pages 12-15).

Defined benefit scheme insurer **Pension Insurance Corporation** (PIC) has lent £50m to **Peel Ports** to fund its infrastructure projects at various British ports.

This 12-year funding takes PIC's interest in the company to £83m following its initial investment back in 2023.

Peel Ports' projects include two ship-to-shore cranes in Greenock, a new roll-on-roll-off berth at London Medway and a warehouse complex in Liverpool.

The **Clwyd Pension Fund** has retained Aon as an adviser.

The firm has supported the £2.5bn local government pension scheme for the past 10 years and will continue to provide governance services concerning issues that include investment, funding and cyber security.

The Citrus Pension Plan, a not-for-profit master trust for defined benefit schemes, has appointed **Russell Investments** to implement its investment strategy.

The strategy will incorporate ESG risks and offer exposure to growth, cashflow-generating funds and liability matching.

Russell will provide access to investment managers and an enhanced governance and operational framework.

Citrus serves 35 schemes with £300m of collective assets for around 3,500 members. It has a co-operative arrangement, in that it is owned by the sponsoring employers and managed by Ndapt, a professional trustee.

The latest DB de-risking news starts with the retirement benefit payments of the UK workers of Caterpillar machinery dealership Finning have been guaranteed by **Standard Life** following a £250m full scheme buy-in.

The deal covers the more than 2,000 members of the **Finning Pension Scheme**.

The trustees of the pension scheme sponsored by insulation-maker **Rockwool** have de-risked the scheme after agreeing a £53m buy-in with **Royal London**.

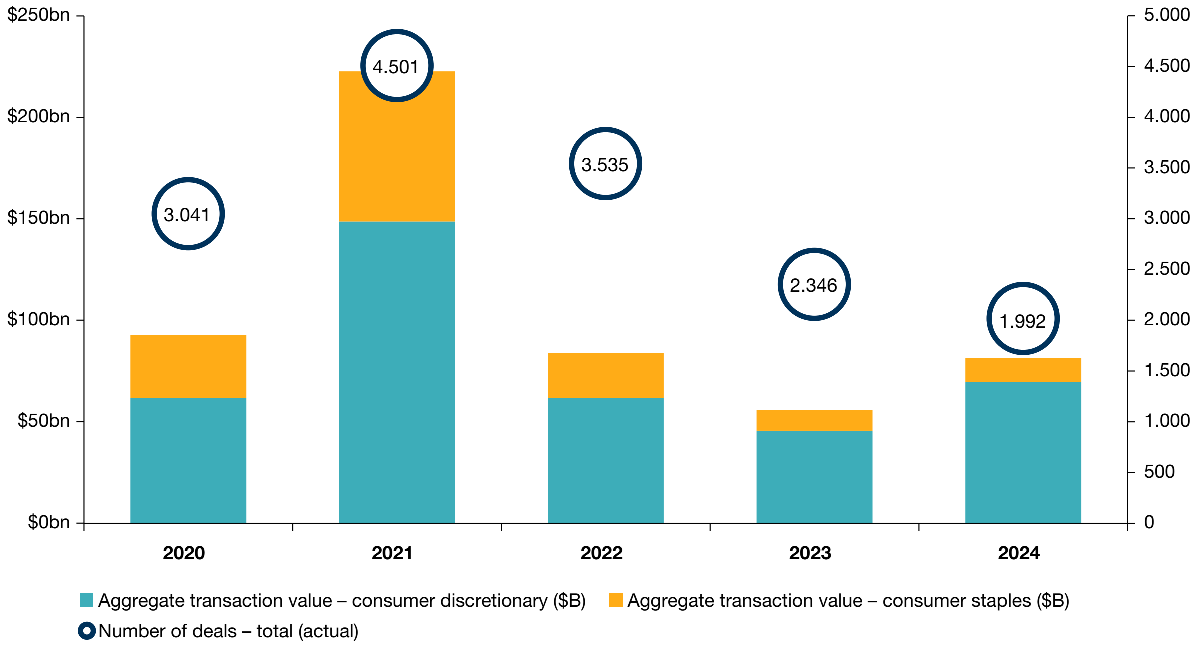
Current and former workers at the UK arm of a drive systems maker have had their benefits guaranteed following a £16m buy-in between **The Deutz Retirement Benefits Plan** and **Just**.

The deal, which covers 181 members, more than 100 of whom are pensioners, was completed in December and was one of 129 deals completed by the insurer, a record for a calendar year.

Finally, Just has also agreed a £1.5m deal to guarantee the retirement payments for the 16 members of the **Geoghegan & Company Staff Pension Scheme**, which is sponsored by Geoghegans Outsourcing, an accountancy firm in Edinburgh.

THE BIG PICTURE: PRIVATE EQUITY FIRMS TARGET CONSUMER CONFIDENCE

Global PE/VC-backed investments in consumer discretionary and consumer staples, 2020-2024



Data compiled Feb. 17, 2025. Analysis includes global whole-company acquisitions, minority stake acquisitions, and asset acquisitions, and rounds of funding announced between Jan. 1, 2020, and Dec. 31, 2024.Source: S&P Global Market Intelligence

Consumer brands are proving to be a popular choice for buyout firms. *Mark Dunne* reports.

The huge growth in private equity and venture capital investments in the consumer sector has continued into this year, says one market watcher.

In 2024, the value of deals in the sector jumped by more than 45% to $81.4bn (£64.5bn), according to research from S&P Global Market Intelligence.

In January this year, 136 deals involving consumer companies were completed for a combined cost of $720m (£57.1m), which the research claims is a sign of momentum in the market.

The sector is traditionally characterised by changing consumer demand, strong competition, sensitivity to the economic cycle and supply-chain issues. However, private equity and venture capital firms see an opportunity to invest in consumer brands to align them with popular areas of the market.

Rising consumer spending and stronger job figures in the US are making distressed consumer brands more attractive.

The research found that corporate carve-outs of specific consumer units are proving a particularly popular strategy among private equity firms.

Last year, buyouts at companies offering non-essential goods and services totalled $69bn (£54bn), which was around 52% higher than in 2023.

Consumer staples saw a slight increase during 2024 to $11.8bn (£9.3bn) from $10.2bn (£8bn) in the previous 12 months, as economic confidence returned and interest rates appeared to be more stable.

On the discretionary side of the sector, education was the most popular being at the centre of 133 deals worth more than $17bn (£13.4bn).

But most of this figure came from the world's largest private equity-backed consumer deal of last year, which was the Canada Pension Plan Investment Board, EQT Private Capital Asia and Neuberger's $14.5bn (£11.5bn) takeover of Nord Anglia Education, a London-based school operator.

After education, car makers saw the second highest dealflow at $11.9bn (£9.4bn) across 51 deals, ahead of casinos and gaming at $7.2bn (£5.7bn) in 18 deals.

Nausicaa Delfas is the chief executive of The Pensions Regulator.

IMPLEMENTING OUR VISION – WHAT YOU CAN EXPECT FROM US THIS YEAR

The pensions landscape is rapidly changing towards one of fewer, larger schemes with new products and services being offered every day. Our mission is to protect, enhance and innovate in savers' interests so that all savers – from every walk of life – can get good retirement outcomes from pensions.

That is why last year we set out that we are shifting our approach to a more prudential style of regulation, addressing risks not just at an individual scheme level, but also those risks which impact the market and wider financial ecosystem.

This year, we will be implementing this vision further.

This starts with an open and transparent dialogue with those who run pensions. We will continue to engage with industry in existing and new ways, so that we hear directly what the challenges are and how we, collectively, can overcome them.

We want to hear your ideas and suggestions. But we also don't want there to be any surprises.

You should be clear on the outcomes we seek for savers, our expectations and what we want you to do to meet those expectations.

Ultimately, we want schemes, advisers and administrators to engage with us early to prevent problems arising later.

We are not interested in just putting out fires. We want to stop things catching alight in the first place. But if people ignore this offer of collaboration, don't be surprised if we step in and intervene in the most appropriate way, using our powers where needed.

Over the next 12 months, we will:

- say more about the need for better data and how we will support you to raise standards, capitalise on new opportunities, and reduce regulatory burden and frictions in how you share information with us
- continue to change how we supervise the most strategically significant schemes – starting with master trusts – to make sure that we anticipate and mitigate future risks to savers, enhance outcomes and foster innovation
- launch our innovation hub to encourage industry to support market innovation and facilitate open and transparent conversations on new models and ideas at an early stage
- set out our future approach to enforcement and tackling serious crimes
- make sure value for money is at the heart of our work, progressing the joint value for money framework, to ensure schemes embed value and ultimately allow savers to choose the right scheme for them
- continue to protect savers' outcomes from climate-related risks and benefit from opportunities from the UK's transition to a net-zero economy
- implement a more strategic approach to raising standards of trusteeship
- help defined benefit schemes consider the full range of alternative models of provision through new guidance

2025 will be a year of decisive action from The Pensions Regulator, with genuine and open collaboration and a focus on long-term outcomes for savers over tick-box regulation.

All this will ensure we meet our goals as a regulator: to protect, enhance and innovate.

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PENSION SURPLUS OFFERS ROUTE TO GROWTH

Higher interest rates may have left many of us worrying about our mortgages, but employers with final salary pension schemes are seeing something quite different: an opportunity to use scheme surpluses to improve member benefits, support their sponsoring employer and, potentially, generate growth in the UK.

After talking for decades about a funding crisis in the nation's £1trn defined benefit (DB) pension scheme sector, successive interest rate rises mean final salary schemes now have a £235bn aggregate surplus.

As things stand, higher interest rates and prudent, professional management by trustees mean the funding position of DB schemes has rarely been stronger.

Neither employers nor their current or past employees stand to benefit from DB schemes being 'over-funded' if that overfunding is not put to some purpose.

This is why many pension managers, even accounting for their legal duty to ensure the members of their schemes get the pensions they are promised, now think there would be benefits, with the right controls, in permitting trustees and employers to put some of these surplus funds to more productive use – for example, enhancing member benefits, DC contributions or investing in growth.

Many schemes' rules allow surpluses to be returned to the sponsor on the winding up of the scheme, others won't.

The treasury's decision to explore relaxing the regulatory regime to allow a surplus to be more flexibly deployed might provoke concern about a repeat of the contribution holidays and surplus extraction from schemes back in the 1980s and early 1990s. Memories of Robert Maxwell loom large in the public consciousness.

However, with more than 30 years of added safeguards and changes to the regulatory regime, including the funding regime, the situation today is incomparable, with strict requirements and severe sanctions for directors and trustees that infringe upon them.

The criteria to allow the extraction of a DB surplus should be that the scheme is well funded with low dependency on their sponsoring employer – a definition set by The Pensions Regulator. Essentially, this would require the trustees to be confident that the scheme could pay member benefits in full, even if there was a change in economic conditions, which impacted scheme funding, that is a buffer that also accounts for investment risks.

Other conditions are that the employer must be in a good financial position with a strong covenant along agreed regulatory definitions. These conditions are important to mitigate the risk of sponsors in financial difficulty seeking to access the surplus of their pension scheme. They will also protect against conflicts of interest that could create moral hazards. For example, where there are employer-nominated representatives, or scheme rules allowing employers to select trustees.

Tight controls should also lessen the impact of unforeseen events in the future that significantly impact a scheme's funding position and lead to member detriment.

So, what actions might sponsors be permitted to take with their returned surpluses?

The potential to increase scheme benefits should be explored, for example, through more generous accrual rates or inflation indexation. Some schemes will have shared cost requirements which have resulted in employees paying higher contributions to close scheme deficits. It would be reasonable for those members to also benefit from any surplus.

Arguably, lowering the legislative threshold for allowing returns of surplus could potentially encourage trustees (in conjunction with their employers) to adopt a more ambitious mindset and take on slightly riskier investment strategies, including greater investment in UK assets.

This could also benefit employers if assets no longer risk becoming 'trapped' in the scheme, which could potentially lead to a different dynamic than existed during the last decade or more between trustees' and employers' investment philosophies around taking on greater risk.

Released surpluses could also be redirected to fund contributions to sponsoring employers' defined contribution schemes. The knock-on benefit for the chancellor is that these funds invest more in assets that drive higher growth – UK shares, domestic infrastructure and private equity.

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Design and production
portfolio Verlag

ISSN: 2045-3833

INTERVIEW – LIZ FERNANDO

"IFM's shareholders needed to be comfortable about letting a Brit into the tent and not destabilise an arrangement that had been working well for them."

In February, government-backed master trust Nest bought a stake in Aussie asset manager IFM Investors. Chief investment officer Liz Fernando gives *Andrew Holt* the inside story.

What was the rationale behind Nest taking a 10% shareholding in IFM Investors?

It is pretty simple. About 17% of our assets are in private markets at the moment, and we have an ambition for that to be 30%. Given the growth in Nest's assets under management, we have a lot of money to put to work and need strong partners to help us.

Private assets are interesting in terms of driving better member outcomes. That is why we are keen to get these assets into the portfolio. And IFM are a fabulous partner. In terms of alignment in motivation, they are owned by 16 Australian superfunds, so it is a good match.

This seems, as other asset owners have said to me, like a potentially game changing move for an asset owner. Is that how you see it?

It is massively exciting and, yes, game changing. This is the first time we have taken an equity stake in a fund management firm that is going to be deploying capital on our behalf. So I guess it shows this type of thing is possible.

It is going to give us a great ability to have better co-creation of new mandates, which hopefully will appeal to other UK defined contribution (DC) schemes. It is unlikely that our requirements are going to be that different to other DC schemes. Hopefully, it is game changing in the sense it will open up the market to other DC schemes.

So you see yourself as pioneers?

If you look at the pensions universe, we already are. I don't think anyone else is doing anything in private markets like us. Some have made various statements about what they would like to do, but I don't think others have money deployed like we do.

You mentioned the motivation for greater private markets investment, but how did you conclude this was the move you should make?

It is fair to say it was a pretty lengthy process, as you would imagine, given the magnitude of what we were considering. Both sides had to be comfortable. Our governance [committee] and board needed to be comfortable. IFM's shareholders needed to be comfortable about letting a Brit into the tent and not destabilise an arrangement that had been working well for them.

The whole motivation from our side was we need high quality, global players to get our capital to work. So the due diligence centred around our confidence in their ability to do that and their team, their record and on designing portfolios.

Those were all the things we were exploring. And given Nest's approach to value for money, we are focused on costs. So that was another part of the conversation.

Was there any push back within Nest? Any scepticism or criticism, or was everyone in agreement?

As you would expect, governance groups ask questions, and as this was a private transaction there was a relatively small group of people working on it. There weren't any pushbacks that I wouldn't expect a high-quality governance group to ask.

The assurance bit was key: how confident were we that they would be able to deploy capital. How confident were we with their team and how confident were we on cost.

You said it was a lengthy process. How long did the agreement take from initial discussions to completion?

About 18 months. It was pretty long, but I was comfortable with that.

You mentioned this agreement is based on boosting your private markets investments. How will that work?

IFM's DNA is infrastructure, and everything infrastructure related: so equity, credit and operating assets. We already have exposures in private credit, which covers infrastructure debt. We have renewables and infrastructure portfolios,

> **One of the challenges of talking to corporates is they get 100 letters from investors asking for slightly different things.**

which cover the equity side of things, and operating infrastructure assets.

We also have a private-equity portfolio. There are probably some interesting areas around the technologies associated with operating assets, that would fit nicely given they are higher growth and potentially slightly higher risk.

So we are looking all around the ecosystem. We think IFM will contribute a lot to the range of our portfolio allocation over the fullness of time.

Are you on target to fulfil your ambition to invest 30% of your portfolio in private markets by 2030?

We still have a lot of work to do. Quite a lot depends on the denominator effects: do equities keep on running? And does the employment market remain buoyant?

We are running to stand still because of the inflows we get, so [taking a shareholding in IFM] will set us well on the course, but we still have work to do.

You said this arrangement focuses on infrastructure, private debt and private equity. Why do you find these asset classes appealing?

Infrastructure and debt are closest to being funded. Private equity is where we see the greatest shortfall between our ambitions and our deployed capital. So that was an obvious place to explore other avenues to try and increase that exposure.

What are the attractions of private markets from an asset-owner perspective?

A few things make them interesting. One is you can get access to return streams from industries that are not available in public markets. So from a portfolio diversification and building higher expected returns perspective, they are interesting.

The second is you usually get paid a premium over what you would get in listed markets because you are taking on complexity risk and illiquidity risk. So the expected returns are higher.

Companies are also listing later in their life. So not only are the number of listed companies coming down, but those coming to market tend to be slightly more mature in their growth cycle. By investing through private markets you get access to those younger companies where the growth and returns are that bit higher.

I guess the final point is private markets tend to be more stable assets. Private equity is slightly different, but a lot of these assets, particularly infrastructure, have stable, predictable returns. That is helpful in a DC scheme. Having that predictability is super helpful.

There are good reasons why DB schemes and high-net-worth individuals have been using these assets in their portfolios for some time.

So you are looking to benefit from companies staying private for longer?

Exactly. A lot of technologies associated with the net-zero transition are difficult things for public markets to invest in, because the timing to generate a profit is quite a long way out. Generally, public markets struggle with that.

You mentioned net zero, how are things on this front given that the Net Zero Asset Managers (NZAM) group has suspended its activities. Does that leave asset owners in no man's land?
We are still committed to our targets. And all our asset managers have committed to the targets we have set for them. Organisations are maybe pulling back from their public pronouncements for business reasons. One can take different views on whether that is appropriate or not.
But at the mandate level, we have been getting reassurances that the asset manager teams will continue to engage and push companies for the changes we are interested in. That is part of our monitoring: making sure they are not rowing back on what they are doing on the ground.

It must have been disappointing that the NZAM initiative was suspended, given the big hitting asset managers that withdrew.
One of the challenges of talking to corporates is they get 100 letters from investors asking for slightly different things. That is complex for them to manage.
The best companies will be doing this anyway but it is potentially a huge drain on resources. For some of those companies who are more marginal on this journey, there is a risk they are not getting a clear and consistent message, which is one of the great virtues of these collaborative investor initiatives. It is going to make it more difficult for those companies to see a clear path forward.

Are you still committed to your targets and the net-zero investor organisations you are a member of?
Yes. We haven't changed. We certainly haven't moved our targets.

Are you speaking to the government about these developments?
That is generally not something we speak about in public. The government needs to set a clear agenda, clear expectations and clear targets. That makes the job so much easier for investors. If everyone knows what the rules of the game are everyone can align behind them. It isn't helpful when the targets are not clear or are shifting.

Is the government doing that?
If you look around the world there are those re-evaluating the feasibility of some of this. There is no point having a target that is unattainable. That is not helpful to anyone. It needs to be realistic, otherwise it loses credibility.

Given what is happening, has the ESG debate become more sceptical and, therefore, more realistic?
It is helpful that investors are thinking long and hard about what they are doing and not making statements in public that they cannot follow through on. People are going back to that principle and checking that they can deliver on their targets. That is a healthy development in the industry.

Back to IFM, is taking a shareholding in an asset manager a move you would recommend to other asset owners?
You need to be of a certain scale to be able to do it. Nest's scale means we were able to do it. But the general principle of partnership with your managers is one of our investment beliefs, in that by having partnerships with our managers we deliver better outcomes. And being shareholders you are more aligned with your manager.

Private equity is where we see the greatest shortfall between our ambitions and our deployed capital.

LIZ FERNANDO'S CV

May 2023 – present
Chief investment officer
Nest

December 2021 – May 2023
Deputy investment officer
Nest

November 2020 – December 2021
Head of long-term investment strategy
Nest

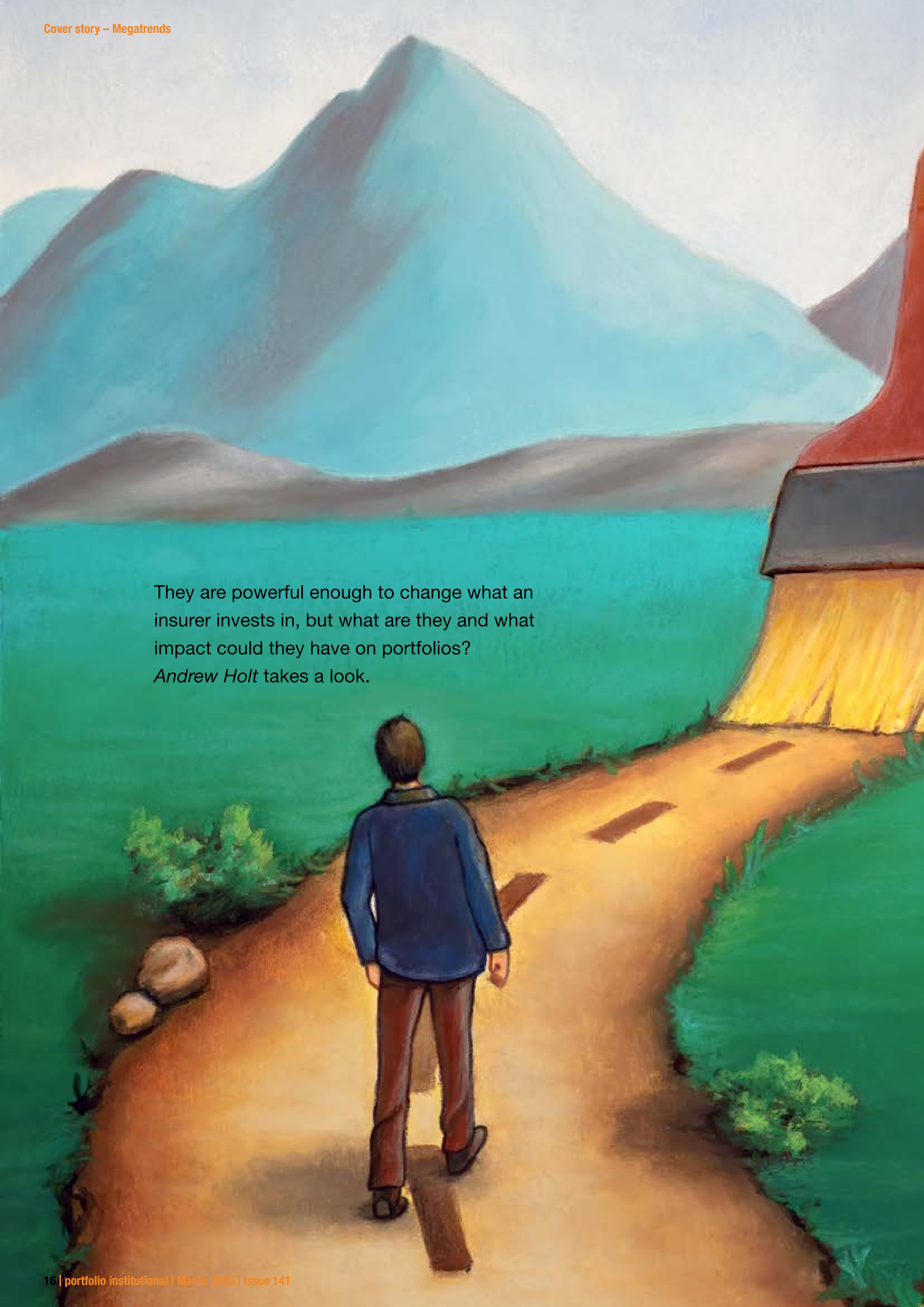
August 2012 – September 2020
Head of equities
Universities Superannuation Scheme

January 2006 – August 2012
Deputy chief investment officer,
head of European equities
Universities Superannuation Scheme

What size then do you need to be to consider this an option?
It depends on the size of the organisation you are talking to. So there is not an answer to that. It probably has much to do with the size of the executive team and the sophistication of the governance to be able to evaluate these opportunities.

Do you have any similar projects planned?
We don't. But it is fair to say the IFM announcement has led to a flurry of emails asking: "What about us?"

Is taking a share in an asset manager an acceptance that some asset managers have failed to deliver in the way you wish, therefore you are trying to shape an asset manager?
No. In this situation it is very much that they are a like-minded partner. We are definitely not looking to fix them. We are looking to take advantage of their skill and talent as leaders in the infrastructure world.



They are powerful enough to change what an insurer invests in, but what are they and what impact could they have on portfolios?
Andrew Holt takes a look.

MEGATRENDS: A NEW PATH FOR INSURERS

A reasonably new idea is seemingly shaping how insurers allocate, and even re-allocate, their investment portfolios. The elaborate name of megaforces hides the fact that they potentially offer investment opportunities and risks in equal amounts. But it is inevitably the opportunities that are shaping the investment decisions made by insurers.

But what are these megaforces? Simply put, they are typically big, structural changes that affect investing for the here and now, as well as far into the future, as their deep changing nature means they will have an impact for years to come.

They are typically drivers of greater macro-economic and market volatility, changing the long-term growth and inflation outlook, and are poised, in the process, to create big shifts in profitability across economies and sectors.

It is no wonder that institutional investors, particularly of the insurer investor variety, look at them with keen interest. Breaking down these megaforces by theme, when asked about their impact by Blackrock, insurer investors identified so called demographic divergence as the structural shift that could provide the most opportunities. "This was consistent across their investment and insurance activities, as well as across all regions and insurance sectors," the Blackrock study read.

Demographic divergence, characterised by shifts in age, income and geographic distribution, is impacting the global economy, as well as specific aspects of the insurance industry. So insurers have skin in the game as they take the lead as institutional investors.

As part of this divergence, life expectancy is rising and birth rates are falling worldwide. As a result, one view is that demographic divergence could be said to be helping to re-shape the insurance industry, forcing insurers to innovate and adapt to new consumer needs and risk landscapes. And with it re-assign their investment portfolios.

Adding detail to the idea, a good example is that in many developed markets, and in particular China, populations are aging and the working-age demographic of 16 to 64-year-olds is set to decline during the next 20 years. This poses economic and investment challenges, as a shrinking workforce means shrinking growth.

Show me the money

Nevertheless, such demographic changes present significant investment opportunities: as populations age, healthcare needs rise. Older individuals also tend to move less frequently, potentially driving a shift in real estate demand. Such an example reveals how from one megaforce idea investment opportunities can quickly blossom.

Francesco Martorana, group chief investment officer at insurance group Generali, lists demographic divergence along with the energy transition and geopolitical fragmentation as presenting risks, but also great opportunities for insurers. "Demand will grow for pension and life-protection products, along with insurance for damage caused by natural catastrophes, opening new market segments," he says.

"Financing energy-transition projects offers capital-allocation opportunities, including public-private partnerships."

The last on Martorana's list, geopolitics, is a central consideration for many institutional investors, but it holds an important place within the megaforce narrative and on the agenda of insurer investors. Martorana notes that geopolitical fragmentation puts some "paradigms of diversification benefits" under the spotlight and creates discussion as an insurer investor, and in addition "international insurance and investment business become more exposed to the risk of regulatory change", he says.

Alex Brazier, global head of investment and portfolio solutions at Blackrock, agrees with this assessment, which brings together demographic divergence and geopolitics. "The re-shaping geopolitical landscape, regional divergence will pose a challenge – and an opportunity – for those managing global balance sheets," he says.

With the development of the health megatrend, which in part grows out of demographic divergence, it is worth noting Japan's healthcare stocks have risen in line with its growing retired population over the past three decades, as measured by the so-called dependency ratio – the stat that measures the number of people who are economically dependent compared to the number of people who are economically productive.

As part of its study into insurer investors and megatrends, Blackrock see similar opportunities in healthcare within the US and Europe, where markets have been slow to price in these demographic changes.

"We see opportunities in emerging markets, where the working-age population is mostly still growing," says Thomas

Regulatory changes continue to bubble along in the background.

Mike Leonard, Aviva Investors

Donilon, chairman of the Blackrock Investment Institute. "We look for countries that can best capitalise on their demographic advantage by improving workforce participation and investing in infrastructure."

As part of this trend, higher returns could well be on offer in emerging countries with greater demand for investment, like India, Indonesia, Mexico and Saudi Arabia, making emerging market equities highly attractive.

Changing allocations

Different sectors face challenges and opportunities, highlighting the need for strategic risk management. Against that backdrop the range of possible returns from different portfolios is greater than in previous decades. Which naturally has an impact on the allocations made by institutional investors, particularly in shaping insurer investor portfolios.

"Static asset allocations are unlikely to deliver as before, a dynamic approach is needed," Donilon says. "These changes necessitate strategic adaptations to meet evolving consumer needs and manage emerging risks."

A point expanded on by Patrick O'Sullivan, head of international insurance solutions at Barings. "There is a shift in asset allocation happening within the insurance world, with more of a shift towards private and alternative credit and away from traditional corporate bond markets," he says.

And the spectre of regulation is also playing its part here. "Across certain regions there is quite a lot of regulatory change," O'Sullivan says. "This is going to be driving a lot of changes in asset-allocation behaviour."

Therefore some insurer investors have made key changes to their portfolio. "Over the past several years, we have transitioned our fixed income portfolio from public corporate bonds to private corporates and securitised sectors," says Glen Gardner, chief investment officer at insurance group Equitable.

The objective here, which could have lesson for other investors, is to generate income, achieve relative value, diversify and invest in new asset classes while maintaining high investment-grade quality. The negatives could be said to include illiquidity, regulatory uncertainty, risk budgeting and potential headline risks.

Gianluca Banfi, head of finance at Italian insurer Unipol, says the asset allocation argument can come down to simply diversification. "A robust diversification strategy mitigates asset price volatility, preserves financial stability and ensures consistent returns even in uncertain market conditions," he says.

Banfi says the group's strategic asset allocation balances growth and risk, considering factors like interest rates and inflation expectations. "In volatile markets we focus on defensive and resilient investments which typically experience lower volatility and stable demand and help cushion the portfolio against severe fluctuations," Banfi says. "We have good liquidity to ensure flexibility, avoiding the need to sell long-term holdings at depressed prices."

> **Static asset allocations are unlikely to deliver as before, a dynamic approach is needed.**
>
> Thomas Donilon, Blackrock Investment Institute

Regulatory change

Within the gamut of megaforces, regulatory change is another re-occurring theme for insurer investors. "Regulation is a critical topic for many chief investment officers," says Henry Ashworth, head of international insurance solutions at Blackrock. "In many markets, particularly those with established regimes, capital requirements are well understood throughout the investment value chain."

The issue being that, as insurers strive to deliver shareholder and policyholder value, an increased need for transparency is paramount, particularly across private markets.

"Delivering these insights to insurers in a consistent and timely manner is critical, particularly as private exposures grow not only to form a material portion of overall allocations but also to play an increasingly important role in asset and liability management," Ashworth says.

The regulatory influence is clearly an important issue and megforce for insurer investors. "Regulatory changes continue to bubble along in the background," says Mike Leonard, head of insurance solutions at Aviva Investors.

"In the UK, changes to Solvency II matching adjustment rules as part of the roll-out of Solvency UK, are expected to increase participation in long-term investment opportunities across UK productive assets," he adds.

No change of appetite

Although in some areas, megaforces are not changing the insurer investor assessment. For example, despite the disruption, insurers expect to maintain their level of investment risk.

> **Demand will grow for pension and life-protection products, along with insurance for damage caused by natural catastrophes, opening new market segments.**
>
> Francesco Martorana, Generali

The majority (74%) of insurers Blackrock surveyed expect to maintain their current levels of investment risk. All regions agreed, with Asia Pacific (68%), EMEA (76%), Latin America (75%) and North America (75%) planning to maintain their risk levels.

Similarly, the majority of insurance-sector respondents aligned – although varying by degree – with life (59%), property and casualty (71%), reinsurers (73%), health (93%) and multi-line insurers (80%) are also expecting to maintain their risk profiles.

When asked for their rationale, the insurers explained that they felt they were already taking sufficient risk given market conditions and that they don't manage investment risk on a standalone basis.

"Our appetite for investment risk is not expected to change fundamentally," says Toshio Fujimura, senior executive officer at Sumitomo Life Insurance. "We analyse market risks based on economic value and balance our portfolio accordingly, and we have enhanced our ability to respond dynamically to market conditions."

And some plain vanilla investments are still going to play their part within the megaforce narrative. "Public fixed income remains central to our investment strategy," says Mark Preston, vice president of investment management at health insurer Humana. "The ability to construct a high-quality, well-diversified portfolio with these assets protects our capital, while the resulting predictable cashflows provide stability and a strong liquidity buffer," he says.

And many insurance organisations are turning to multi-alternative solutions to achieve a range of objectives – such as liability matching, yield enhancement and capital appreciation.

So even within these insurer investor trends, public fixed income continues to play a fundamental role in insurers' investment portfolios, given its potential to provide stable and predictable income streams that match liability outflows in a capital-efficient manner, according to Blackrock's study.

Let's be private

Like much of the investment world, there is also an increase in deployment into private markets, as insurer investors plan to increase their allocations to alternatives, with 91% planning to do so within the next two years, according to Blackrock. This figure increases to 96% for Asia Pacific and North American insurers, respectively.

Insurers cited diversification and lower volatility, the opportunity to invest in new asset classes, and the ability to increase income generation as top drivers for changing their exposure to private markets.

"Private assets provide access to opportunities not easily found in public markets, including various types and sizes of companies and targeted strategies especially impact investments, which enhance portfolio returns and diversification," says Don Guo, group chief investment officer at insurer Prudential.

"They also help dampen portfolio volatility, particularly from non-fundamental, technical-driven fluctuations in public markets," he adds.

One particular factor is shaping insurers' investment portfolios increase in private markets strategies. "A major reason for accessing this componentry has been to improve risk and return diversification, and this will continue to have a major effect on the composition of portfolios," Leonard says.

"We value capturing the illiquidity premium and investing in private assets to diversify our portfolio," adds Equitable's chief investment officer Glen Gardner. "We see opportunities in asset-backed finance, corporate private placements and infrastructure debt holdings, which enhance yield without increasing overall credit risk," he says.

Private-debt growth

Looking at this trend further, the insurers Blackrock surveyed are most likely to increase exposure to opportunistic private debt (41%), private placements (40%), direct lending (39%) and infrastructure debt (34%).

As a trend, private debt has grown beyond middle-market lending to include any financing directly originated, structured and held by the lender. "We believe this expansion will continue, driven by changes in the bank lending ecosystem, public-debt markets and public-equity markets, which are broadening private debt's addressable market," says Amanda Lynam, head of macro credit research at Blackrock. "We expect private debt's growth – in size and scope – to create new opportunities for partnership with insurance companies."

The 2025 edition of Aviva Investors annual private markets study found that more than half of institutional investors globally, including insurers, expect to increase their allocations to private markets during the next two years, with 56% now allocating 10% or more of their portfolios to these strategies.

"That's a result of the perceived returns on offer," Leonard says. To prove the point, while 70% of respondents to the Aviva study mentioned diversification as their main reason for allocating to private markets today, the illiquidity premium that private markets assets can offer is emerging as a real driving force for further allocations, with 47% of investors highlighting it as a key reason for allocating to private markets assets in the next two years.

And playing an important role is the fact that generating capital yield is a key consideration for chief investment officers at insurance companies. Insurers have looked to broaden their investment universe to include investment-grade private, less liquid and structured investments to improve yield per unit of capital.

These investments have typically yielded more than a comparable liquid fixed income with a similar rating and duration profile. They can also be structured to enable attractive risk versus reward dynamics for insurance balance sheets.

There is a belief that the total market for private debt will continue to grow, along with insurance-specific holdings of illiquid debt, revealing an interesting and specific megaforce in itself, propelled by insurer investors. Thanks to the continued reduction in bank lending caused by competition for deposits and increased regulation, non-bank lending terms have become relatively more attractive and more important as a source of financing for economic growth. Non-bank lending has therefore grown globally.

The expansion of private debt issuance across various loan, collateral and borrower types, includes consumer finance, hard assets, commercial finance and contractual cashflows, presents a wide-ranging opportunity set for insurers.

> **Our appetite for investment risk is not expected to change fundamentally.**
>
> Toshio Fujimura, Sumitomo Life Insurance

Keeping it clean

Inevitably any megaforce discussion has to lead at some point to clean energy infrastructure. Wind, solar and transition technologies, such as batteries and energy storage, are top thematic areas that insurers are focused on.

Among insurers planning to increase allocations to transition-related investments, impact strategies, emerging markets, growth/buyout private equity exposure and infrastructure are the preferred investment approaches and exposures, according to Blackrock's study.

"Through the Insurance Development Forum, we have identified infrastructure debt as a key segment that supports electricity generation and enhances the resilience of emerging markets by financing critical assets," says Jean-Baptiste Tricot, chief investment officer at insurer AXA.

And like much of the institutional investor world sustainability is likely to remain a major force in shaping insurer investment portfolios. Interestingly, the Aviva study supports that view within private markets allocations as well, with three-quarters of investors globally considering it as either a critical factor or one of several factors in investment decisions.

"It also underscored a continued preference for sustainable investment opportunities that can also combine financial performance with positive societal and environmental impact," Leonard says.

Thinking ahead

There are other, more basic reasons for insurer investors to consider megatrends. "It's important that insurers always think ahead, particularly when it comes to the external environment and the potential of exogenous events to change the shape of their liability risk profile," Leonard says.

"These events can have knock-on consequences when it comes to cashflow-profile requirements for insurers and therefore may affect the types of underlying assets they will consider," he adds.

"In time, its potential to impact the investment universe available to insurers means it is something we believe should be factored into thinking now. Doing so will help insurers stay on top of the changes and understand any potential impacts on investment approach," Leonard says.

"So, while we don't think we'll see this materially impacting investment activity right now, it's something insurers should – and will – be keeping a close eye on."

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US EQUITIES: CURB YOUR ENTHUSIASM

The result of the US election may have boosted the country's stock markets but investors may need to rein-in their longer-term expectations, finds *Andrew Holt.*

Since the election of Donald Trump the investment world has been unable to contain its enthusiasm. US equities have boomed with the S&P, Dow and Nasdaq hitting record highs. Investors are clearly excited by the president's policy agenda of reducing red tape, cutting taxes and supporting American infrastructure projects. Forget Make America Great Again, it is more a case of Make American Stocks Great Again.

"Investors view a Trump presidency as broadly positive news for the performance of US companies and the large US-listed technology stocks," says Miranda Seath, director of market insight and fund sectors at the Investment Association.

This booming market position looks set to continue. The S&P 500 is projected to climb further in 2025, according to Goldman Sachs' research. The index of the largest 500 listed companies in the US will hit 6,300 this year, up from the current 6,066, the asset manager says.

The investment team at UBS are even more positive. They predict the S&P reaching 6,600 by the year-end. "The Trump presidency", UBS notes, "has the potential to reshape the global economic and geopolitical landscape."

From what we have seen from Trump so far, that looks to be his ambition.

In addition, Goldman Sachs' research forecasts growth in earnings-per-share of 11% in 2025 and 7% next year. "Robust earnings growth should drive continued equity market appreciation," David Kostin, chief US equity strategist at Goldman Sachs, wrote in the research.

Corporate America is therefore in good shape. "US corporate earnings are forecast to grow in the mid-double digits next year," says Tom Stevenson, investment director at Fidelity International. "American companies are expected to grow faster than their peers in the rest of the world, with higher returns on capital."

Trump: the winners and losers

One key question surrounds which sectors are set to benefit during Trump's second term. Given the president's agenda, these are not difficult to identify.

Fossil fuel stocks should ramp up given Trump's "drill baby, drill" dictum. US steel producers should also profit, given that the industry should be a beneficiary of Trump's tariffs. Banks should see some boom given the financial regulatory loosening promised by the new administration.

Trump's friends in Silicon Valley should also see their backing of his presidential campaign reap rewards. "Tech companies have been lobbying Trump's administration for more favourable treatment in areas such as tariffs, AI regulation and anti-trust regulation, and we can expect to see this continue," says Ben Barringer, global technology analyst at Quilter Cheviot.

The magnificent seven, which generated more than half of the S&P 500's total return in 2024, are likely to again have a major impact on returns this year, which potentially points to a positive US equities picture. Although this should come with the caveat that only seven stocks driving gains within an index is not a great position over the long term.

And US small-cap stocks should also stand to benefit from the ongoing deglobalisation of supply chains – the so-called reshoring or onshoring trend. The Russell 2000 index, which tracks US small cap companies, has already seen substantial gains.

"Small and mid-cap companies are much more likely to have customer bases that are either exclusively or predominantly in the US," says Bob Kaynor, head of US small and midcap equities at Schroders. "For that reason, small and mid-cap stocks can provide investors with more direct exposure to the US economy."

And there are thousands of small-cap companies to choose from in the US stock market, so investors could be said to be spoilt for choice when it comes to the small-cap universe.

In addition, small-cap earnings are already expected to rise 16% in 2025, according to investment firm Cambridge Associates. And, if tax cuts are enacted, they should disproportionately benefit, given that more of their revenue is generated domestically compared to their large-cap peers.

The stock losers under Trump, are likely to be in three areas. The first, will inevitably be those associated with renewable energy, given Trump's position on climate change, which he has described as a "hoax," and the fact that one of the first acts of his presidency was to withdraw from the Paris Agreement for a second time.

Then there are pharmaceutical companies. Trump's pick for secretary of health and human services, Robert F Kennedy, is a long-time critic of the healthcare sector, vaccines and big pharmaceutical companies, so the industry is likely to face some difficult days ahead.

Finally, companies that are dependent on complete global supply chains – of which there are worryingly many – are likely to be losers under Trump. The standout sectors that could suffer most are electronics, footwear, the car industry, and food and beverage companies.

Equity boost

The other narrative set to boost US equities is the economy. Expectations for this year point to a robust economic growth picture. Asset manager Candriam anticipates 2.6% GDP growth in the US, driven by strong labour markets, solid consumption and increased investment in the technology sectors.

"We are overall constructive towards equity markets, favouring American stocks," says Nadège Dufossé, global head of multi-asset at Candriam. "Even though the performance and valuation of the American stock market already reflects some optimism, the growth trajectory of the US economy and corporate earnings is much stronger and more resilient than that of other developed countries, such as Europe," she says.

The view that the US economy is in a good shape is shared by Tom Stevenson. "The US economy was growing faster than the rest of the developed world even before Trump promised to pour fuel on the fire," he says.

And Laura Cooper, global investment strategist at Nuveen, says the US economy is a strong driver behind its markets. "We still think the US market offers the best combination of relative safety and growth against a backdrop of the US economy poised to outperform," she adds.

Cooper also notes that some of Trump's polices are likely to directly benefit US equities. "The US administration's likely prioritisation of domestic growth through tax cuts and deregulation should be supportive of a broadening rally within US equities," she says.

Given the focus on tariffs, the Trump trade could well be good for riskier business. The HSBC multi-asset team has outlined an "extremely positive" backdrop for risky assets. In a mind-boggling metaphor the team described this opportunity as "Goldilocks on steroids".

Julian McManus, a portfolio manager on the global alpha equity team at Janus Henderson Investors, says the main risks are likely to be volatility centred around geopolitics, given that Trump's appointments point to a hardline hawkish policy, particularly relating to foreign policy and trade.

"Risk is very much back on the table, and volatility will be rising," McManus says. "Investors will likely seek companies that are resilient to this – and for us that means staying focused on those that generate healthy levels of free cashflow."

Reasons to be cheerful

This upbeat outlook is not the whole story. For all the positive noise surrounding the Trump effect on US equities, there are a number of reasons for investors to curb their enthusiasm. The first can be seen within the bond markets, which has seen something of an unsteady start to 2025.

The bond market usually sniffs out a problem long before other parts of the market do. Treasury prices have fallen with concerns that Trump will borrow more money, putting further pressure on the government's finances. The US budget deficit already stands at $1.9trn (£1.5trn).

And bond yields rise when prices fall. At the time of writing, the 10-year US treasury yield stood at 4.56% compared to 4.28% on the day of last year's US presidential election, that is

The US economy was growing faster than the rest of the developed world even before Trump promised to pour fuel on the fire.

Tom Stevenson, Fidelity International

“

Risk is very much back on the table, and volatility will be rising.

Julian McManus, Janus Henderson Investors

a decent fillip in a short period. It provides problems for the equity market, as rising bond yields increase companies' cost of raising capital.

Then there is the strength of the US dollar, which appears to be something of a safe haven in times of crisis, or a potential crisis on the horizon, and has negative implications for listed corporates. “A stronger dollar for longer erodes US multi-nationals' external competitiveness, creating a potential earnings headwind,” says Peter van der Welle, a sustainable multi-asset strategist at Robeco.

Research by the asset manager shows that a slowdown in global trade volumes is typically associated with a stronger US dollar, which also sees equity markets trading lower. The 2018/2019 tariff announcements during the first Trump administration showed that the S&P 500 as well as it's Chinese counterpart the CSI 300 traded around 2% lower in the subsequent 20 trading-day period.

Inflationary impact

The inflationary environment could also be one to watch as a result of the Trump tariffs. “Global inflation no longer appears to be retreating, notably in the US, due to uncertainties surrounding the Trump administration's programme,” says Annah Malik, an analyst at asset manager Edmond De Rothschild.

This potential inflationary environment could mean the Federal Reserve's ambitions for interest-rate cuts are scuppered. “Potential tariff-driven inflation risks may keep rates higher for longer, while the president's promised de-regulation push could further fuel economic growth – and inflation along with it,” says Adam Singleton, chief investment officer of external alpha solutions at Man Group. “In such a scenario, the Fed would have little justification for cutting rates.”

A more negative scenario is that interest rates will need to rise before they can fall and with it have a harmful impact on the US equity market, says Eric Souders, a director and lead strategist on the Payden and Rygel global unconstrained fixed income team. “Higher long-end yields will cause asset prices to cool down, demand to slow and inflation to abate,” he adds. “This might mean a mediocre 2025 for equities and credit and a challenging environment for bond yields.”

Power of the US

The wider problem is if US equities experience difficulty then global investors suffer. As an insight into their power and importance to all investors, US stocks now account for more than 67% of global equities, as measured by the MSCI All Country World index.

There is also one political-related risk with investment implications: the Trump presidency could turn into cabal of his friends, where the government does nothing more than impose less regulation, lower taxes and higher spending in specific areas that satisfy Trump's pals.

Such a situation, if it were to become the norm, would not be good for US equities or the US in general. Such a scenario “can degenerate into an ever-more unequal and indebted nation with less dynamism and greater risk of bubbles”, says Dr David Kelly, chief global strategist at JP Morgan.

A final issue cited by some commentators, is that the US equity market is seen as expensive, meaning there is little room for equities to move upwards. But there are different ways to read this, as Duncan Lamont, head of strategic research at Schroders, points out.

“The US being expensive is not a new phenomenon, nor is the relatively high weight of the US in global markets,” Lamont says. “US stocks also have a lot going for them, including soaring US productivity versus the rest of the world, better economic momentum, and corporate buying,” he adds.

But there is one important factor that means investors are likely to stick with US equities, no matter what. “The fear of missing out makes it difficult to turn your back on winning investments,” Stevenson says.

And US equities have proved time and again they are very much winning investments. “It would be eccentric not to have an exposure to the world's most dynamic and innovative economy in your investment portfolio,” Stevenson adds.

But such enthusiasm is likely to be curbed to some degree. Lisa Shallett, chief investment officer at Morgan Stanley Wealth Management, has said she is expecting rises in US stocks of between 5% to 10% this year. This not bad in itself, but is well adrift of the 20% and above levels that became the norm during the past two years.

This probably represents where investors need to be when approaching US equities: curbing their enthusiasm while still picking up decent returns from Trump's market winners.

MARCH 2025

pi ESG CLUB

Achieving net zero is one of the toughest challenges of our time, a challenge that is getting tougher. This month's ESG Club looks at how institutional investors are making their portfolios more sustainable in the face of rising political headwinds.

THE SHIFTING SANDS OF ESG INVESTING

Sustainable investing faces challenges on a number of fronts, not least from some of its asset managers. *Andrew Holt* reports.

It is a critical time for environmental, social and governance (ESG) investment – with the impetus of investors addressing climate-related issues either waning or going into reverse.

After many big-hitting asset managers left the Net Zero Asset Managers group, which led to the suspension of its activities, some reports suggest many asset managers are not meeting companies on ESG matters.

This could be a slippery slope where ESG no longer remains a key priority. This follows the Glasgow Financial Alliance for Net Zero (GFANZ) – a group of various financial institutions – to be the latest industry or sector body to change its mission due to pushback on ESG issues.

The group said it will restructure and shift its focus to addressing barriers to mobilising capital, but will no longer be aligned with the Paris Agreement. In a statement, the group said: "GFANZ will transition to an independent principals group, led by chief executives and leaders from financial institutions acting to address barriers faced in mobilising capital for the transition around the world – including sovereign wealth funds, financial institutions, and market participants in countries with longer transition pathways."

Responding to this, Jeanne Martin, head of banking programme at responsible investing campaigner Share Action, said: "We cautiously welcome GFANZ's new focus on addressing barriers to mobilising capital, which is critical to achieving net-zero by 2050."

However, she added GFANZ's decision to walk back on a requirement to align with the Paris Agreement is a "dangerous one". This "could lead to its members lowering ambition even as climate change impacts like extreme weather are harming communities around the world", Martin said.

"GFANZ members have a critical role to play in mobilising capital to achieve climate goals," she added.

The International Energy Agency has warned that private finance needs to contribute $3trn (£2.3trn) out of the $4trn needed annually by 2030 to face down the transition challenges.

Share Action's research found that banks' incoherent climate targets are unlikely to shift enough financing away from fossil fuels towards green activities such as renewable energy at the pace and scale needed to avert the climate crisis.

"To be effective in delivering the climate action the world needs, GFANZ and its sub-alliances should reaffirm a requirement to align with the Paris Agreement," Martin added. "GFANZ should ensure its members not only mobilise capital for the real economy transition but also phase out from fossil fuels."

New low

The reappraisal or even rejection of ESG standards by some investors could already be here, at least according to the latest data. Research by Share Action shows that asset managers' support for shareholder resolutions aimed at tackling social and environmental issues crashed to a new low in 2024 with less than 2% of proposals being approved, down from more than a fifth three years earlier.

Asset managers who voted against shareholder resolutions designed to protect human rights, nature and climate included the four largest asset managers in the world: Blackrock, Fidelity, State Street Global Advisors and Vanguard.

Collectively managing $23trn (£18.2trn) in assets, more than the GDP of the European Union, these firms, Share Action said, "have an outsized influence through the huge investments they hold in key companies" – yet collectively supported only 7% of key shareholder resolutions.

Share Action's research reveals an additional 48 shareholder resolutions could have passed had these four asset managers chosen to support them.

Claudia Gray, head of financial sector research at Share Action, said: "This is the worst result we've seen from asset managers in the six years we've been monitoring their voting performance and shows a worrying retreat from ambition when it's most needed."

And she added: "As support for shareholder resolutions hits rock bottom, our first ever analysis of votes against resolutions proposed by company management paints a similarly bleak and disappointing picture, with asset managers failing to use these votes to hold companies accountable for their social and climate impacts."

Had asset managers supported them, proposals put forward by shareholders at 190 companies could have improved conditions for low-paid workers and driven urgent climate action, noted Share Action in the report.

This could be of deep concern to asset owners who are putting their faith in asset managers to act in their best interests.

As in previous years, there is a striking gulf in performance between asset managers in the US and Europe. Supporting 81% of shareholder proposals on average, UK and European asset managers have once again demonstrated greater commitment to responsible investment than their US counterparts.

This, it should be noted, is in the context of higher corporate transparency standards set by regulators in Europe. But with a strong anti-ESG sentiment sweeping across America, the division between the US and Europe is likely to get even bigger.

INTERVIEW – EMMA DOUGLAS

"The industry can sometimes put too much weight on impact investments instead of encouraging more traditional investments to improve real-world outcomes."

The sustainable investment and stewardship lead for the body which runs the BT Pension Fund tells *Andrew Holt* about integrating sustainability into all portfolios, the unintended consequences of nature and why it's business as usual for diversity.

How would you describe your role?

My focus is on sustainable investment and stewardship. I look at the sustainable investment strategy, thematic work and social issues such as DEI, as well as manager oversight of the sustainable investment approaches.

Sustainability is integrated throughout our investment approach. On the portfolio construction side, there could be work on the data front, while the manager research team might look at specific strategies. I will then work with the team and provide specific expertise, as and when is necessary, to help the investment decision making.

So you don't have a bucket for sustainable investment – it is in all of your investments?

Sustainability factors are considered in the investment process to improve risk-adjusted outcomes. Therefore, it is considered for all of the portfolio. We call it a horizontal approach, rather than a vertical and stand-alone function.

What is your approach to investing sustainably?

We set up a four-pillar approach when thinking about our net-zero ambition. So we have portfolio construction, mandates and managers, stewardship and advocacy. We also have a fifth pillar, Brightwell corporate, so our sustainability approach is aligned throughout the organisation.

We have evolved our approach from thinking about ESG risks to focusing on systemic risks and opportunities – so thinking about nature, climate and inequality. And because we encourage a more holistic approach, focusing on sustainable outcomes is linked to improved risk-adjusted investment outcomes over the long term for our clients.

When we were thinking about net zero previously, it was perhaps more about an isolated risk to the portfolio. But as time has gone by, we have realised the inter-connectedness of sustainability risks, which means they cannot be tackled in isolation.

Are any of these pillars more important than the others, or are they integrated?

They are integrated, but it is also about taking a nuanced approach. We focus on what we consider to be the most material risks and opportunities. We do materiality mapping to understand the sectors most exposed.

There is a theory behind it: water scarcity, for example, is a key risk and comes up in many portfolios.

It sounds like you have been on an evolving journey over the last few years.

Absolutely. Within the industry there is now more talk about the inter-connectedness of these risks and thinking about them together and the trade-offs. This comes back to being able to link our sustainability approach to generating the right outcomes for our clients.

Are you at the end of this developing process?

Everything is a form of continual evolvement – as it should be. Sustainability moves on quickly. New technologies are changing. We need to keep up to date, but we are happy with where we are and remain pragmatic with how we evolve.

How do these approaches sit within the overall Brightwell/BT Pension Scheme portfolio?

It is an integrated and pragmatic approach, so we do not necessarily focus on small allocations to an impact portfolio, for example.

It is thinking about what will drive real-world change. We could easily decarbonise the portfolio overnight by getting rid of the top emitters, but that is not going to have

real-world impact. We want to encourage those who might not have committed to the energy transition to do so over time.

Could you give me an example?
We have examples within our real estate and infrastructure investments – last year we took the BT Pension Scheme members to an energy recovery facility that is in the portfolio.
The industry can sometimes put too much weight on impact investments instead of encouraging more traditional investments to improve real-world outcomes. A combination of things are needed to drive that real-world change.

> **We want to encourage those who might not have committed to the energy transition to do so over time.**

So that real world change is key?
It is key. We can reduce portfolio emissions through exclusion, but that doesn't do anything to the level of emissions in the atmosphere.

What are you looking to do next with your sustainable investments?
We are always researching new developments – how managers are assessing opportunities around biodiversity. But we are focused on research and understanding portfolio risks and opportunities at this stage.

About 18 months ago you undertook a project with the Cambridge Judge Business School to look at nature-related risks. Why did you do that and what did it reveal?
That was a good starting point for our nature work. From the outset we felt we needed to understand how nature had an impact on the portfolio, which is a complicated topic. We felt that it was necessary to get a good grounding in what the risks could be.
We also wanted to understand how nature connects with climate and feeds into portfolios as well as how our managers are thinking about this.

Is this part of a wider commitment to biodiversity?
It could be. Many organisations are setting biodiversity targets, but we are not in this position. With nature we have to be mindful that there could be unintended consequences to setting nature targets.

You have committed to carbon neutrality by 2035. That is quite ambitious, but is it realistic?
It is ambitious. We have made good progress in reducing emissions across all asset classes for one of our clients who also has a net zero by 2035 ambition.
I would say by starting earlier, it has focused our minds and opened up longer-term opportunities. We have also said that progression might not be linear and that we are dependent on global developments.

Are the government and supranational bodies doing enough to create a framework on sustainability, net zero and climate change that investors can follow?
There is always more to do in these areas. In general, we are proponents of using industry frameworks. We are mindful that governments are working on a shorter timeframe of four-to-five years. Our clients are long-term investors, so we have that in mind.

Is it frustrating that the government is working on a different timescale to institutional investors?
We always want to see more ambition to move the sustainability agenda along. We are seeing good progress, generally with much wider adoption and understanding within the market. Even over the last five years there has been significant change in the awareness of climate change.

> **We value collaborative initiatives, particularly around systemic risks like climate change.**

On that though, is the Net Zero Asset Managers initiative suspending operations after the withdrawal of several big asset managers a concern?
It was disappointing to see that happen. We value collaborative initiatives, particularly around systemic risks like climate change. It cannot be tackled alone. But

there is now a greater appreciation of the nuances around climate change. You are balancing real-world decarbonisation versus portfolio decarbonisation.

We continue to engage with managers on this topic and want to see their climate activity continue. Whatever the forum they want to do it in, continue the work that has to be done. I don't want the ambition to be scaled down.

Does the suspension of the initiative create an uncertain future?

We haven't heard what the outcome could be. It could bounce back, maybe with some nuances and terms changed or updated, but the suspension has raised significant concerns over its future and made it public.

Do you think the same could happen with the asset owner equivalent?

We are operating in a different environment. So my expectation is that the asset owner equivalent will continue. We get a lot of value out of collaboration and sharing knowledge across asset owners.

Does the wider critical focus on ESG concern you?

We need to be mindful of the developments on a global scale. Our clients are investing for the long term and we need to do everything that is in members' best interests.

We are not working in four-year cycles, so providing our managers follow what we want them to do, we hope it is business as usual.

Are asset managers up to speed on all things sustainability, net zero and ESG?

There is a range of expertise and focus in the market. Some are leaders, others are catching up, but the majority are up to speed.

What is more debated is on the specifics and the time horizons. Things like oil and gas – at what point could they become stranded assets? That is a key question. Do you engage, divest or benefit from potential short-term profits?

What do you do in such a situation?

We want to facilitate the transition to a lower-carbon economy and a more sustainable world. We invest and don't have blanket exclusions but what we do is engage to ensure companies are aligning with a lower-carbon economy over the long term.

If that engagement is unsuccessful over time, then we could look to divest if we felt there was a detrimental impact to our risk-adjusted outcomes.

So effective stewardship is important?

It is huge. We place a lot of emphasis and value on stewardship.

How do you approach stewardship?

We work with EOS at Federated Hermes: they are our stewardship provider. We also get involved with some collaborative initiatives and engagement. For example, we have just signed up to Nature Action 100.

We engage with our managers to understand their stewardship approaches and push for alignment to the ambitions of our clients: whether that be net zero or something broader.

We will make sure they are aligning with engagement activities, which hopefully will lead to positive outcomes over the coming years.

Is the investment industry collectively doing enough on ESG-related issues?

There is always more to do in this space. We now have more understanding of the risks and opportunities, and this is developing each year. We have gone from thinking about climate to an industry, now looking more at nature and I can see social being the next focus.

One final point on diversity, has it dropped off the investment agenda?

I would say it is more discussion than it is action at the moment, but it is evolving. Particularly in Europe and the UK, I am not hearing or seeing companies dramatically change their approach as they consider it a way of improving company performance. The situation is different in the US.

EMMA DOUGLAS' CV

January 2022 – present
Sustainable investment and stewardship specialist
Brightwell

February 2020 – January 2022
Responsible investment consultant
Lane Clark & Peacock

August 2018 – February 2020
Associate investment consultant
Lane Clark & Peacock

July 2016 – August 2018
Investment analyst
Lane Clark & Peacock

August 2014 – July 2016
Actuarial analyst
Aon Hewitt

There is now a greater appreciation of the nuances around climate change.

020

How are institutional investors setting winning climate strategies in the face of rising uncertainty? *Mark Dunne* reports.

Our climate is trying to kill us. Floods, wildfires, droughts – they just keep coming.

The good news is we can save ourselves. The climate-changing greenhouse gases emitted from everyday activities like farming, manufacturing, traveling and heating our homes are making our planet warmer and therefore causing such extreme weather events.

Lowering these emissions so they can all be absorbed by carbon sinks, such as forests, the oceans, soil or machines, could keep global temperature rises to 1.5°C above pre-industrial levels, a safe average set by the Paris Agreement.

Many governments, including Britain's, along with institutional investors have set 2050 as a deadline to achieve just that.

The bad news is we have reached a point where progress on achieving net-zero emissions appears to be easing when it needs to accelerate. Following years of rapid growth, momentum is losing its edge in the face of political and economic issues.

"Limiting [global] warming to 1.5°C [by 2050] is out of reach," says Mhairi Gooch, senior responsible investment consultant at Hymans Robertson.

Gooch, who leads the firm's net-zero work, describes the target as "ambitious but plausible" back when the Paris Agreement was set 10 years ago. But today it appears progress has not moved as fast as predicted.

However, all may not be lost. "Limiting warming to below 2°C is still very much in reach," Gooch says, before adding that a temperature rise of at least 3°C is likely.

NET ZERO: HARD TARGET

Troubling times

Green is falling out of fashion. Low economic growth, wars in Europe and the Middle East boosting fossil-fuel stocks and lawmakers in the US are to blame. Indeed, with growth becoming a rarity in the developed world, governments are having to decide between meeting their sustainable goals or boosting their economies.

In Britain, not everyone is confident that hitting net-zero emissions can be achieved within the next 25 years. The Climate Change Committee, which advises the government, has warned that progress is slow.

The lack of optimism can be put down to the slow adoption of heat pumps, plans to expand London City Airport, the proposed new runway at Heathrow and awarding new oil and gas licences, of which there were more than 80 in the final quarter of 2022. If the plan is not to increase the greenhouse gases in our atmosphere, the UK appears to be on the wrong path.

There is also a backlash against attempts to create cleaner sources of energy, especially in the US. Sustainable regulation is set to become a lot looser, if not reversed under President Trump who has already quit the Paris Agreement.

In some states, the backlash has led to litigation. In November, Texas attorney general Ken Paxton sued Blackrock, State Street and Vanguard. He believes their efforts to phase out oil and gas could cause higher energy bills. Blackrock has since pulled out of a large asset management alliance aimed at achieving net zero.

Yet for the pension schemes that asset managers like Blackrock work for, mitigating the material financial risk of climate change is part of their fiduciary duty. And the financial risks are getting worse.

Extreme weather patterns have caused more than $3.6trn (£2.8trn) worth of damage since 2000 and could knock more than a fifth (22%) off GDP by the end of the century.

Research from AXA shows that investing 2% to 3% of cumulative global GDP in mitigation and adaptation measures could prevent 10% to 15% in GDP losses.

Yet investment in sustainable funds globally fell by half in 2024, compared to the previous year, despite inflows into the wider fund universe being the second highest in the past seven years thanks to a rally among US stocks.

If this continues sustainable assets under management could be worth $35trn (£28trn) in the next five years, Bloomberg Intelligence believes. This is a downward revision on the previous estimate of $40trn (£32trn).

Indeed, the era of impressive sustainable investment growth between 2016 and 2022, which saw such assets under management grow by 10% a year to $30trn (£24trn), appears to be over. Bloomberg Intelligence predicts that litigation risk and negative sentiment will see the US' share of such assets under management drop from 30% to below 20%.

This comes despite Bloomberg Intelligence predicting that low-carbon companies will see their earnings jump by more than a quarter this year, beating the 18% expected by the benchmark.

How to achieve net zero

With so much uncertainty and with a changing geopolitical situation, how are pension schemes approaching the transition to a regenerative economy?

For Jennifer Devine, head of the Wiltshire Pension Fund, climate change is an important consideration when managing its investment portfolios. "As an open defined benefit scheme we are going to be here for 100 years, so it is something we have to think about," she says.

> **We are here for 100 years, so have to look beyond short-term noise.**
>
> Jennifer Devine, Wiltshire Pension Fund

Wiltshire builds its investment strategies around the various scenarios of how climate change could impact the scheme's investment returns and funding positions.

"Obviously, anything looking into the future is an approximation, and methodologies change," Devine says. "We have tried to make it as evidence based as possible, so the committee can put numbers around this big concept and make proper decisions off the back of it."

Of course, there is no one-rule-fits-all to decarbonising portfolios. Different asset classes need to be approached differently. If you want to clean up your equity holdings, you could look at the scope one and two emissions. If you are looking at property, there are the EPC ratings or you could examine the methods of construction.

Wiltshire also has a dedicated climate portfolio to tap directly into the transition, such as investing in renewable infrastructure or funding tech designed to reduce the carbon in our atmosphere. "That portfolio is trying to come at the problem from every angle," Devine says.

The Wiltshire Pension Fund has set a target of cutting 50% of its carbon emissions by 2030. "I don't know if we will hit that target on the nose," Devine says. "It is a bumpy journey; it is not going to be a smooth path.

"Massive global macro-economic events over the last five years have thrown us quite a few curve balls," Devine adds, pointing to the invasion of Ukraine and its impact on energy stocks as an example.

"We set ourselves quite an ambitious target initially, and whether we will hit that or not, I don't know, but we have been making progress in the right direction."

For Gooch, a credible net-zero strategy has to be thinking about the real-world effect of the decisions investors make. Selling high-emitting companies is just shifting the problem around.

"Our core message this year at Hymans is about investing in reducing emissions, not reduced emissions," Gooch says. "Everything is about transition. We have to transition all parts of all sectors, industries and economies. That includes emerging markets and fossil fuels. They all need to transition and quite quickly."

Craig Campbell, UK head of responsible investment at Aon, agrees that divesting is simply passing the problem on to somebody else. "It is much better, albeit difficult to measure, to use your role as an active steward of capital to engage better behaviour towards decarbonisation."

It's good to talk

Deciding where to invest is not the only lever asset owners can pull to make their portfolios carbon neutral. "Engagement is absolutely essential, and you have to constantly raise the bar on this," Gooch says.

And the engagement side of portfolio management always needs to be improved. "There is obviously a lot of backlash on ESG, in the US in particular," Gooch says. "That is where we just have to go stronger as asset owners, on our beliefs as these are important topics.

"They are financially relevant. They underpin our economies and financial system. They should not be an afterthought," she adds.

German sports car-maker Porsche is one corporate where investors have much to discuss with management. The company is believed to be set to continue making petrol-powered cars for longer than planned due to demand for one of its electric models collapsing by as much as 50% in the first nine months of 2024.

Then there is BP. There are fears the oil and gas giant could move away from renewable energy as falling profits have left its share price depressed and some of its shareholders are demanding change.

This comes as a coalition of global pension schemes and insurers collectively managing $1.5trn (£1.2trn) worth of assets has called on their peers to improve how they interact with their portfolio companies to fight the financial impacts of climate change.

The Asset Owner Statement on Climate Stewardship, which counts the stewards of some of the largest pots of retirement savings in Britain as members, wants asset owners to ensure that their asset managers meet their net-zero expectations.

"Time is running out in the lead up to 2030," Leanne Clements, head of responsible investment for People's Partnership, said in a statement.

"Asset owners and asset managers must work together in partnership to drive meaningful change – not only in the companies in which we invest, but in the underlying economic, social and environmental systems upon which our members depend," she adds.

And asset managers are failing to use their votes to hold companies accountable for their social and climate impacts. Their support for shareholder resolutions aimed at tackling social and environmental issues slumped to a new low in 2024, according to responsible investing campaigner Share Action.

Only four out of 279, or 1.4%, of the shareholder proposals assessed by the campaigner received majority backing, down from 21% in 2021.

The Wiltshire Pension Fund holds the asset managers who are not delivering their sustainable goals to account, and publicly in various reports. "We are not secret about what we are doing," Devine says.

For Campbell, this is important. "You are relying on asset managers to invest money on your behalf in line with your goals," he says. "It is absolutely crucial to ensure that managers are engaging with companies to decarbonise them in line with your goals."

A credible net-zero strategy has to be thinking about the real-world effect of decisions.

Mhairi Gooch, Hymans Robertson

A sound stewardship strategy offers many benefits, Devine says. "Engagement can help not only reflect what the beneficiaries want, but you can also use it to set an example in the industry as well."

But engagement can only take your portfolios so far and for Campbell this could mean you achieve "near zero". "Before the endpoint you will have to invest in a carbon-offsetting strategy, because there will be some emissions in the portfolio that will just be too hard to abate," he says.

Meet the new boss

One area where engagement may not help is with the new president of the United States, who wasted little time pulling out of the Paris Agreement, so does his election make net zero by 2050 more less likely? "Over the last five years, we have weathered some significant events," Devine says. "We saw our returns chart plummet and come back up again during Covid and have seen wobbles around the conflict in Ukraine. Although we want to understand how our investment managers are dealing with those issues, it doesn't impact our strategy.

"We are here for 100 years, so have to look beyond short-term noise," she adds. "We still believe, and the modelling shows us, that net zero by 2050 is the right outcome financially for our pension fund. So we won't change our strategy off the back of short-term political noise."

Trump has created more uncertainty, but longer term there is potential for sharp shifts in policy once he departs. "While we are not on track today, there is a significant level of expectation that policy will shift in the future to help bring us into that position," Gooch says. "So for pension schemes, building a net-zero strategy should be about navigating this transition that is already underway has plenty of momentum and that we will likely see further shifts in the future."

We need them. If they don't come our climate will continue to try killing us and the generations that follow.

DIVERSIFICATION: RISKS AND REWARDS

Is there too much focus by UK pension schemes on domestic markets at the expense of geographical diversification? *Gill Wadsworth* reports.

Once the champions of domestic investment, UK pension funds' allocation to British companies is at an all-time low.

Defined contribution (DC) funds' allocation to London-listed equities plummeted from 40% in 2012 to 8% eleven years later. Meanwhile defined benefit (DB) funds investment in the UK's stock market has dropped from 32% in 2006 to just under 2% by 2023. Even the local authority pension scheme's (LGPS) commitment to UK equities has more than halved during the past decade falling from 25% in 2013 to around 10% today.

Therefore total UK pension allocations to domestic assets are far lower than the equity share held on home turf in Canada (22%), New Zealand (42%) and Australia (45%).

Figures from think tank New Financial show the story is repeated in private investment where UK pension funds have a 6% allocation to domestic private equity and infrastructure assets; far lower than their peers in Canada (34%), Finland (17%) and Australia (14%).

William Wright, founder and managing director at New Financial, says this allocation to domestic equities is among the lowest of any developed pension system around the world with only Canada, the Netherlands and Norway having a lower allocation. "It is less than half the weighted-average allocation to domestic equities across our sample, excluding the US," Wright adds. "The overall allocation to equities by UK pension

funds of 30% is lower than every market except Canada, Denmark and the Netherlands."

Destroying the doom loop

This, Wright says, has created a "doom loop" of lower demand, lower valuations and a less dynamic UK market.

No wonder then the UK government is desperate to break the vicious circle and bring some assets back home.

Last August, chancellor Rachel Reeves said UK schemes should "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".

The government is now in the midst of a far reaching pension review which could see sweeping reforms designed to "unlock billions of pounds of new investment for the UK economy and boost returns for savers".

Although what this rhetoric will actually mean for pension funds is the key point of discussion, and why the outcome of the review and its subsequent consultation are being anticipated so eagerly.

In the meantime, pension trustees and those responsible for the investment of the nation's retirement funds can continue to allocate to strategies that favour global diversification, which reflect the international nature of equity markets.

Chris Arcari, head of capital markets at Hymans Roberson, says: "Many institutional investors have shifted equity allocations towards positions which are more representative of the UK's increasingly smaller weight of global market capitalisation."

Lok Ma, trustee director at independent pension trustee firm Law Debenture, says it makes sense to have a geographical spread to offset the risk of regional volatility.

But he notes, with geographical diversification comes geopolitical risk. "Diversification across geography is obviously a sensible thing but you have to think about the geopolitical considerations," Ma says. "While diversification is a great thing, if it all goes horribly wrong there is a real chance you won't get your money back."

While UK schemes were relatively well insulated from the impact of Russia's invasion of Ukraine in 2022, several multi-billion-pound schemes including the National Employment Savings Trust (Nest), Universities Superannuation Scheme and Transport for London were all forced to withdraw assets from the region as a result of the conflict.

Arcari says the challenge for those at the pension investment coalface lies in the almost complete inability to foresee such calamitous events. "It is difficult to pre-empt or trade political instability and macro-economic volatility," he adds. "The only free lunch in this regard is to have a diversified portfolio with assets which might provide offsets in certain circumstances."

Arcari says that given current bond yield levels, these assets are "well placed to provide ballast in a garden-variety downturn or shock". For example, one where growth and inflation, or at least expectations of them, fall sharply.

"However, diminishing returns from globalisation, disruption to supply chains from climate change and geopolitical tensions, and political opposition to immigration as a cure to more persistently tight labour markets, mean we are potentially entering a more fragile supply-side environment than in the post-global financial crisis period," he adds.

Trade wars

There are also impacts from the trade tariffs imposed by US president Donald Trump and the subsequent expected retaliation from affected countries.

This February, President Trump signed an executive order imposing an additional 25% tariff on steel and aluminium imports into the US, due to come in during March.

While there is still room for negotiation, Ewa Manthey, commodities strategist at ING, says many countries are ramping up their defences, making further trade escalation inevitable.

"President Trump has laid the foundations for further trade escalations. This will not be the last tariff move. Retaliation is on, and it's going to get nasty," Manthey says.

The question for investors is whether a "nasty" trade war means they retreat from those markets they believe will be wounded in battle.

> **The overall allocation to equities by UK pension funds of 30% is lower than every market except Canada, Denmark and the Netherlands.**
>
> William Wright, New Financial

Tom Stevenson, investment director at Fidelity International, says: "The consensus, outside the Trump administration, is that tariffs are bad news. The view is that the threat is serious, and it will cause a big economic growth hit, for the US and its trading partners, as well as an inflation surge in America."

However, it is also possible that deepening hostilities between major economic forces result in a form of de-globalisation that makes it even more important for pension funds to have exposure to different geographies.

For Ma, we might be moving into a more segregated world as a result of trade barriers. "I have seen an argument that says, actually that makes a stronger case for diversification, because the markets are less correlated with each other which means your gains in one place could offset losses in another place to a greater extent than before," he says.

Global credit markets

While UK pension funds have shown appetite for overseas equities, their taste for foreign fixed income has been more muted.

As DB schemes mature, they have chosen to de-risk with many choosing to shift to fixed income, specifically UK government bonds which are closely aligned with their liability profiles.

However, research from JPMorgan Asset Management warns investors against an over-reliance on UK bonds, specifically gilts reminding investors of the fallout from the September 2022 crisis.

"It is prudent to consider global diversification of the core fixed income portfolio, across government and corporate bonds.

"The sterling market, while important, is dwarfed by the immense size of the global credit market – there are about 750 bonds in the UK credit market versus about 7,800 in the global credit market ex-UK, and the market capitalisation of UK credit is a mere 5% of the global credit market," the research read.

Hedging the risk

Irrespective of whether you opt for overseas bonds or stocks or a mixture of both, investing abroad brings the risk that foreign currencies fall against the pound. Obviously, this reduces the value of your international assets and either means that future returns need to be higher, or contributions must rise to make up for the shortfall.

How trustees approach currency hedging is scheme specific, but Arcari at Hymans says it has an important impact on fixed-income allocations. "The volatility reducing effect of hedging fixed income exposures is far more significant for fixed income exposures than it is for equity and other growth asset exposures. The higher the volatility of the underlying asset, the smaller the gain in terms of volatility reduction from hedging the currency that is achieved.

"For this reason, we would suggest hedging all fixed income exposures as standard," Arcari continues. "Currency hedging, of course, incurs a cost, so it is understandable that schemes might be more cost effectively able to invest in sterling-denominated fixed income assets."

Ajeet Manjrekar, global co-head of client solutions at Schroders, agrees that fixed-income assets should typically be fully hedged back to sterling, while for "on-risk assets held to generate growth, schemes may choose to hedge a proportion of the overseas currency risk".

President Trump has laid the foundations for further trade escalations.

Ewa Manthey, ING

There are tactical reasons why a pension fund may choose to leave a proportion of their exposure unhedged. Allocations to safe haven currencies – those from countries with stable governments, central banks and financial systems where investors take shelter in challenging economic conditions – often strengthen in challenging market conditions. Ma says: "I've seen more and more schemes deliberately retain some exposure to currencies like a US dollar; it's a downside risk management strategy. If there is global uncertainty, the dollar tends to strengthen which can offset some of your losses elsewhere."

Going private

While the propensity from UK pension funds has been to journey overseas to help manage risk and deliver return, there is a growing trend to consider homegrown alternative investment options.

The government is desperate to use UK pension funds – particularly the £3trn held in workplace schemes – to bolster its growth and net-zero ambitions by channelling assets into domestic unlisted equity and infrastructure projects.

Several of the UK's largest DC schemes have committed to allocating at least 5% of their default funds to unlisted equities by 2030 as part of the Mansion House Compact, but this will take time and raises questions about whether the government is interfering decision-makers' fiduciary duties to members.

When asked whether UK schemes should favour domestic allocations to unlisted assets, Manjrekar says: "It depends on each scheme's specific investment needs, trustee beliefs and risk appetite. Where UK assets provide attractive risk/return opportunities whether in public or private markets that align to the specific scheme's needs, then this statement is fair."

Meanwhile, Arcari says: "For schemes with a desire to deliver local impact and invest in UK productive finance then there is potentially a greater role for sterling-based assets in private markets.

"The UK can also be attractive from a private markets' perspective given the strong regulatory framework and protections that apply to provide some certainty over income or return streams, albeit some assets can come with a higher price tag."

When you are sitting on one of the largest pension markets in the world, it is undoubtedly frustrating for government and business that so many trillions of pounds in assets are heading out of the UK and overseas.

Yet pension funds exist solely to provide financial security for their members in retirement and that means investing where they will get the best risk-adjusted returns. UK policy can – and likely will – adapt to make the UK more attractive to its pension funds, but ultimately it will always make sense for schemes to hold at least some of their portfolios abroad.

THE FINAL COUNTDOWN

40%
A third of master trusts intend to invest at least 40% of their illiquid allocation in UK assets.
Source: Isio

9.1%
The earnings of Japanese corporates are expected to grow by more than 9% this year, beating 2024's 7.9% estimate.
Source: Asset Management One

11.9%
The decline in venture capital deal volume globally during 2024 to around 10,300 transactions as early-stage funding rounds fell by almost 15%, year-on-year.
Source: Global Data

$35trn
The expected size of global ESG assets under management by 2030, a downward revision from the previous $40trn prediction in the face of lower growth and a political backlash in the US.
Source: Bloomberg Intelligence

$160bn
Direct lending-focused funds' dry powder reached almost $160bn at the end of January. The figure has grown each year since 2010 as demand for non-bank lending rises.
Source: S&P

$966bn
The proceeds generated by green, social and sustainability bonds in 2024, an 8% increase in 12 months to its highest level for three years.
Source: MainStreet Partners

81%
The fund managers who expect a "significant" increase in inflows and product launches this year on the back of demand for alternative assets and ETFs.
Source: Carne

£92.7bn
The forecast headline dividends to be recommended by Britain's boardrooms this year, only 0.7% higher than in 2024 thanks to expected lower special payments.
Source: Computershare

37%
The level of professional investors who anticipate increasing their exposure to active ETFs in the next 18 months, while only 1% intend to cut their allocation.
Source: Fidelity International

Quote of the Month

"There is a fixation of liquidity in some investing, but I don't want DC members to be day traders."

Alan Pickering, Best Trustees