A question of balance

Marcus Mollan reveals how Aviva manages the tricky balance of leading the way with sustainable investing, while ensuring secure, long-term returns for its annuity business

"It is no longer considered necessary to sacrifice returns to invest sustainably," says Aviva's annuity asset origination director, Marcus Mollan. "In fact, taking account of environmental, social and governance (ESG) factors, and adopting a sustainable investment approach, is critical; it is another level of due diligence that allows you to manage some of the most significant long-term investment risks and to enhance the risk-adjusted return you will achieve over the long term."

Aviva has been involved in sustainable investing for many years now; from a time when far fewer people were convinced that investing in this manner didn't have to mean giving up returns.

It was ahead of the curve in its concerns about carbon emissions. For instance, in 2006, the company was the first carbon-neutral international insurer, and it has now reduced its CO2 emissions by 60 per cent, relative to its 2010 baseline. Also, in 2015, Aviva made a public commitment to invest £500 million annually in lower carbon infrastructure. It has already smashed that target, with nearly £4 billion invested in low-carbon infrastructure, particularly in the renewable energy sector, as well as over £1 billion in green bonds to support the transition to a low carbon economy.

More widely, when it comes to aligning the needs of its annuity business with sustainable investing, Aviva mainly turns to social infrastructure, often in the form of private infrastructure loans, due to their relatively low risk and predictable cashflows compared to equities.

"We take our responsibility to make regular pension payments very seriously. Our customers rely on us and so we need reliable cashflows from our investments for decades. The investments we make need to stand the test of time and be fit for purpose in a changing world," Mollan says. "That naturally leads us to look at areas like social infrastructure, which are fundamental to society and have a long-term timeframe."

While Aviva's percentage allocation to private assets has increased lately, as it invests more in infrastructure, real-estate debt and equity-release mortgages, Mollan predicts that the rate of increase may slow as the company needs to maintain a balance of publicly-traded assets to ensure it retains sufficient liquidity and flexibility in its portfolio.

But while the ratio between public and private assets may remain largely stable, the amount of private assets held within Aviva's portfolio will likely increase as their annuity business continues to grow.

As a key part of the strategy for this expansion, Aviva understands the importance of building a diversified portfolio to balance its exposure to different risks. Therefore, Mollan says, as well as ensuring the company diversifies by investment type, it is also increasingly diversifying by location.

Aviva is currently expanding its asset allocation to regions outside the UK, particularly into Europe and North America, with recent private loan and infrastructure investments in France, Germany, Canada and the USA. However, Mollan adds, "with overseas investments, we have to use derivatives to convert the cashflows from these assets back to sterling, and we need to lock in the conversion rates for many years in advance. These derivatives can introduce new risks and potential costs. Sometimes the risks or costs are not worth bearing. We have to ensure we're getting an acceptable rate, after allowing for all the implicit and explicit costs of going overseas."

As well as going abroad, Aviva is also turning to whole new sectors for investment opportunities. Within infrastructure, there are new options coming to market all the time, Mollan explains.

Many of the current areas of interest arise from the UK's commitment to become a net zero carbon economy by 2050. "This will require some dramatic

changes to how we generate energy, how we deliver it to businesses and families, and how we power our transport systems. There will be no single energy source that will fill the gap left by de-carbonisation; achievement of the country's targets will require investment and innovation on multiple fronts. We'll likely see a very significant increase in offshore wind farms, the use of bio-energy, carbon capture and storage, the use of hydrogen gas, and potentially more reliance on nuclear power. Heating, insulation and energy efficiency technologies for both new and existing housing stock will also become an area of focus."

When considering investing in new areas, Mollan highlights the importance of "doing your homework". Aviva takes a rigorous approach to this, initially considering how much the new opportunity diversifies its portfolio and seeking an understanding of the source and sustainability of the underlying cashflows. If it sees an attractive-looking opportunity, it will conduct a deeper analysis of the dynamics of that particular market, its long-term prospects and how the market is structured. Particularly in the area of infrastructure, this will usually include an analysis of the regulatory and political dynamics of the market and how these might evolve over the long term. The underlying revenue streams will then undergo stress-testing against different scenarios, to check the robustness of the expected cashflows.

As a lot of new projects are riskier in early years, Aviva's annuity business typically lets other parties take the bulk of the investment risk, and allows them the biggest return opportunity, in these early stages. The reason for this is that privately-traded assets can be hard to exit if things go wrong, he explains. "Taking a risky equity-like position is not consistent with our need to achieve secure, reliable cashflows to back our annuity liabilities. We will usually seek at least an investment-grade quality loan exposure, and this can require a more mature market. So, we will often sit out the very early stages of development of a market. But once we are satisfied that we can achieve the right sort of risk exposure, and the right return opportunity, we can invest in very large size," Mollan says.

For all of this work, Aviva's annuity business makes extensive use of the private assets teams in Aviva Investors, who lead the on-the-ground sourcing of new asset opportunities. "Asset origination for our annuities business is very much a partnership between the life insurance company and the fund management teams at Aviva Investors," Mollan states.

Aviva also looks to its in-house investment company for advice on ESG policy, and discusses with Aviva Investors' Global Responsible Investment team how ESG issues apply both to sectors and to particular investments. Mollan gives the example of the debate on fossil fuels, considering whether it is best to be divesting or engaging with firms in this sector.

"We need to strike the right balance," he says. "Simply divesting from a company can sometimes be appropriate, but in many cases more of an engagement-driven approach is better to try and change behaviour and can be more effective."

In 2018, Aviva Investors engaged with 91 countries about climate change. Alongside the efforts of other asset owners, Aviva's engagement with oil companies in particular helped to create a significant change in those companies' stance, with the oil majors now broadly welcoming the Paris Agreement, which united the world's nations in an effort to combat climate change.

Within the coal sector, Aviva believes that any plans for new investment in coal-generating capacity are inconsistent with the Paris Agreement. Aviva has divested from 18 companies within this space and is also engaged with several more companies to ensure that they have the appropriate plans to achieve the necessary transition.

Engagement such as this is traditionally considered the preserve of equity holders, due to their ability to vote in shareholder meetings. However, Mollan notes that, while bond holders and loan lenders do not have that direct voting option, they do still have a position of significant influence, which is increasingly being recognised.

New equity issuance is relatively uncommon, he explains, but new borrowing opportunities, or companies looking to get better rates on their borrowing, is common. "Whether we are happy to keep supporting them for loans gives us a point of engagement and power as they may be looking to us for more financing in the future."

This, Mollan states, is a change in dynamic.

"Large debt holders like us will be more bullish and sophisticated in how we use that power to get the right changes taking place from a governance perspective. This is something that we and other large debt holders will be looking at more seriously over time."

There is still a lot of room for investors to work more closely together, he adds. In November 2019, Aviva was one of the insurers and pension funds signed up to the Net Zero Asset Owners Alliance, pledging to have a zero-emission investment portfolio by 2050, and Mollan believes that with increasing alignment between major asset owners, a significant impact can be achieved. "As a single investor, Aviva is already making an impact. However, as we see the industry align behind an ESG agenda I believe this could drive even more significant and positive change."

Aviva investment director, Marcus Mollan

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