For professional investors

Diversified private markets: Sustainability+?

Trustees face increasing pressure to conform with ever-changing ESG and climate reporting requirements and demand from members. Consequently, DB and DC schemes embrace ESG-aligned benchmarks with enthusiasm, but does investing via low carbon indices go far enough?

The International Energy Agency (IEA) has highlighted the need for $4 trillion annual investment by 2030 to facilitate the clean energy transition and meet the global aspiration for net-zero emissions by 2050. Is there therefore a case for trustees to consider making explicit allocations to climate change related investments beyond simple low carbon passive solutions? The MSCI ACWI Low Carbon Leaders Index (in US$ terms) returned 16.5 per cent in 2020 versus 16.3 per cent for the MSCI ACWI Index. Over the same period BNPP AM's active Energy Transition Fund net of fees returned 164.6 per cent (in € terms) versus 6.7 per cent for the MSCI ACWI Index. Allocating capital to ESG and climate aligned thematics can add genuine value for members and more explicitly direct capital to climate change investments.

Whilst such approaches offer the opportunity to capture what will be a multi-decade trend in equity markets some investors are wary of the volatility associated with equity investments so are there alternatives for trustees seeking to better align portfolios to the Paris Agreement?

Negative real yields, negative cashflows, pressure to diversify risk exposures, funding ratio/price volatility, a focus on costs and changing investment regulations are additional pressures that trustees face when considering investment strategy. These make holding listed equities harder, while low bond yields add to the challenge of sourcing adequate real returns. In this context, one way to improve the risk/return and climate profile of institutional portfolios is to capture illiquidity premiums by investing in diversified private debt and private equity portfolios that also directly finance the creation of green assets, aligned to the Paris Agreement.

The challenge

Many institutional investors have shunned the volatility associated with listed equities and have simply invested in other asset classes. For example, defined benefit pension funds have been steadily moving out of traditional listed equities and into fixed income, index-linked and corporate bonds over the years. By 2020, their equity allocation stood at less than 20 per cent *[Pension Protection Fund, Purple Book, 2021]*.

As an alternative, many institutional investors started investing in UK gilts and listed high-quality corporate bonds. However, their nominal yields have steadily fallen over the past 20 years (with the exception of 2008/2009 during the height of the global financial crisis). Consequently, for the past few years, real yields have been either low or negative (depending on their maturity).

The solution

Private markets can be an attractive substitute to listed equities and bonds, particularly when combined to form diversified portfolios and allow schemes to own directly assets that are linked to the energy transition.

• **Private equity** (PE) is defined as capital invested in companies that are not publicly traded. This asset class includes traditional leveraged buyouts and venture capital (VC) as well as infrastructure (infra) equity and direct real estate (RE) investments.

• **Private debt or credit** is defined as capital invested in the debt of private companies. Private debt is not traded or issued in an open market. It generally includes asset classes such as corporate lending (to SME and mid-market companies), real assets such as infrastructure debt and commercial real estate (CRE) debt.

Whilst offering lower immediate liquidity (as most of these assets are valued once a month or once a quarter and are usually held to maturity) private debt and equity may offer a number of advantages over their listed equivalents.

• Higher returns, captured through an illiquidity premium.

• Lower volatility and a lower market beta.

• Potentially more targeted environmental, social and governance (ESG) oriented investments (based, for example, online by-line selection of well defined green, sustainable and social projects).

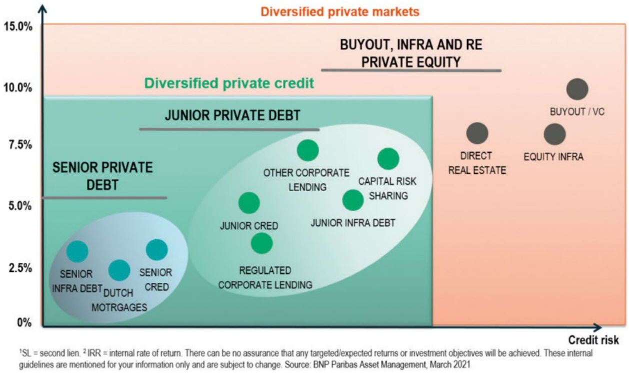
The investment universe

Chart one provides an overview of the investment universe encompassing diversified private credit and equity:

Strategies for investing in private credit and debt

In practice, asset managers have developed different types of investment strategies to meet investors' objectives

Chart one



Source: BNPP AM, November 2021

when entering the private credit and private debt universe:

• **Diversified private credit** strategies generally aim to incorporate various types of real asset debt and corporate lending with some structured finance sub-asset classes and to capture a credit illiquidity premium. They offer a blend of senior and mezzanine investments, countries, currencies, credit ratings and liquidity. They can be structured as cashflow matching portfolios and can be suitable for mature defined benefit pension schemes (cashflow negative with a large majority of retirees).

• **Diversified private markets** strategies add exposures to private equity, direct real estate and infrastructure equity to a diversified private credit portfolio. They aim to capture a blended illiquidity premium. They are structured as alternative growth engines and are suitable for defined benefit pension schemes with active members and defined contribution pension plans with long time-horizons. They typically offer higher expected returns with lower volatility levels than their listed counterparts.

Because of their nature, these strategies are customised to individual client needs with varying features:

• The investment universe can be narrow (for example, focused on corporate lending) or wide (including semi-liquid asset classes such as leveraged loans).

• Fund design – they can be open-ended or close-ended, unitised as a Luxembourg RAIF or a UK-based LP.

• The strategic asset allocation (SAA) can be directive or just indicative, with loosely set ranges allowing for active asset allocation over time.

• They can be evergreen or established only for a pre-determined amount of time.

• They can rely on a fund-of-funds structure or include only single-line investments.

• Diversified private credit and private market strategies can be structured as bundled solutions with streamlined custody, depositary, fund and loan administration services. This helps avoid the complexity of managing multiple illiquid mandates and funds with different service providers. Many institutional investors that pursue a diversified approach are struggling to efficiently manage the complex capital call schedules, as well as principal and interest payments.

For all these reasons, diversified private credit or private market approaches have advantages over investing in single asset classes as well as over listed asset classes.

Other benefits

Beyond the much improved risk/return profile that can be obtained at the portfolio level by combining different private debt and private equity sub-asset classes, it is worth noting that there are other important benefits.

Relative value based asset allocation can be achieved across the investment universe. Depending on the manager and the investment vehicle, the solutions also benefit from holistic risk, liquidity and cash management by a single team, ensuring consistency and coherence.

Diversified private debt and private market solutions have established strict governance arrangements that enhance the flexibility of the SAA and allow for innovation and nimble assessment of investment opportunities as they appear. For example, an annual or semi-annual investment committee meeting can be convened to assess new asset classes, eg credit risk sharing, as they arise or full discretion can be afforded to the asset manager.

Crucially in the context of the pressures faced by trustees, ESG and climate change considerations can be embedded in the private debt and equity transaction filtering and selection process. This provides investors with greater confidence in the quality of their investment portfolios, and a better alignment with pension scheme members beyond passive index or active thematic equity options.

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