CAMRADATA

Alternatives Roundtable

What's the Alternative?

January 2019

Sponsored by

Allianz Global Investors | MV Credit | nuveen REAL ESTATE

Clear and Independent

Institutional Investment Analysis

We provide institutional investors, including pension funds, insurance companies and consultants, with data and analysis to assess, research and report on their investments. We are committed to fostering and nurturing strong, productive relationships across the institutional investment sector and are continually innovating new solutions to meet the industry's complex needs.

We enable institutional investors, including pension funds, insurance companies and consultants, to conduct rigorous, evidence-based assessments of more than 5,000 investment products offered by over 700 asset managers.

Additionally, our software solutions enable insurance companies to produce consistent accounting, regulatory and audit-ready reports.

To discuss your requirements
+44 (0)20 3327 5600
info@camradata.com

Find us at
camradata.com

Join us on LinkedIn

Follow us on Twitter @camradata

Contents

A Reminder About Our Aims

Investors will eternally seek long term alpha, and in today's markets, this has led to their exploration of less traditional fund offerings. Enter the alternative…

Institutional Investors are increasing their allocating to 'Alternative' solutions, and this is only set to rise; PWC[1] is predicting alternative allocations will grow to between $13.6tn and $15.3tn by 2020.

Investors are looking beyond traditional equities and bonds more than ever before, with a number of top 10 pension schemes stating that they are investing up to a third of their strategies in alternatives.

Does this mean, therefore, that we are nearing a point where alternative strategies have not only become mainstream, but are also starting to take the limelight?

Allocating to alternative strategies has many benefits for institutional investors, including the ability to achieve diversification and flexibility, alongside long term steady returns. Whether looking at investing in renewables, infrastructure, leasing or credit; seemingly private market investments are beating the wider market.

That said, arguably alternative investments can come with challenges. Can the illiquid nature of these strategies be overcome? Are their fees pitched at a level that are too high for the institutional investor? How are they currently regulated, and will this change going forwards? And in a world where monitoring the performance and risk of pension schemes is more prevalent than ever, can one receive transparency across these types of solutions?

Alternatives; are they durable and are they profitable?

"Investors are looking beyond traditional equities and bonds more than ever before, with a number of the top 10 pension schemes stating that they are investing up to a third of their strategies in alternatives."

1 https://www.pwc.com/jg/en/publications/alternative-asset-management-2020.pdf

Sponsor

Allianz Global Investors

Company Profile

Allianz Global Investors is a leading active asset manager with over 700 investment professionals in 25 offices worldwide and managing more than £460 billion in assets for individuals, families and institutions.

Active is the most important word in our vocabulary. Active is how we create and share value with clients. We believe in solving, not selling, and in adding value beyond pure economic gain. We invest for the long term, employing our innovative investment expertise and global resources. Our goal is to ensure a superior experience for our clients, wherever they are based and whatever their investment needs.

Active is: Allianz Global Investors
Data as at 30 June 2018.

Adrian Jones

Director, Alternative Assets

Adrian Jones is a senior portfolio manager within the Alternative Assets division at Allianz Global Investors. Adrian has worked in capital markets for nearly 25 years on both the 'buy side' and 'sell side', developing new investment opportunities including repackaging traditional banking products for institutional investment.

As a key founding member of the Allianz Global Investors Infrastructure Debt investment platform, Adrian has helped to give pension funds and insurance investors access to infrastructure debt products traditionally financed by banks in investor-friendly private bond format, including raising and managing two sterling investment closed-ended funds.

Before joining Allianz Global Investors in 2012, Adrian worked for MBIA UK Insurance Limited where he structured transactions for investors in the European public finance and real assets sector including credit insurance products, asset-swaps and other repackaging transactions. Following the financial crisis Adrian was extensively involved in restructuring and work-outs resulting from the downgrade of the financial sector including the ultimate parent of MBIA UK Insurance Ltd itself.

Adrian has experience in commercial banking and investment banking, insurance and asset management. He has worked in M&A, financial advisory (for private and public sector clients), corporate and project debt arranging and equity investment (including serving as a director of private companies acquired as part of investment strategies), asset repackaging and restructuring.

Adrian started his career with ANZ Investment Bank and subsequently worked for Schroders, Citigroup, Deloitte, and MBIA UK.

Adrian holds an MA from St. Edmund Hall, Oxford University.

Sponsor

MV|Credit

MV Credit Partners LLP

Company Profile

MV Credit Partners LLP ("MV Credit"), an affiliate of Natixis Investment Managers, was established in 2000 as a leading pan-European provider of credit financing solutions to leveraged buyout transactions, backed by reputable private equity sponsors.

MV Credit has advised credit funds, investing over €5.3bn across over 500 financing solutions to Western European Leverage Buy-Outs. The prime consideration in all these investments has been the presence of strong management teams and stable cash flows.

The majority of the senior members of the MV Credit Team have been working together since the formation of MV Credit in 2000 with some having worked together since 1994.

Murtaza Merchant

Partner and Head of Fund Optimisation

Murtaza joined MV Credit in 2006 and is currently the Head of the Fund Optimisation Team. His responsibilities include, amongst other things, managing the leverage and financing facilities of the funds, analysing and structuring of new business ideas and driving innovative initiatives to enhance fund returns.

Prior to MV Credit, Murtaza was an Investment Manager at Industrial and Financial Investment Company (IFIC). Murtaza holds a Bachelors degree in Commerce (with Distinction) from University of Pune in India and passed the Intermediate level at the Institute of Chartered Accountants in India.

Sponsor

nuveen
REAL ESTATE

Nuveen Real Estate

Company Profile

Nuveen Real Estate is one of the largest investment managers in the world with $125 billion of assets under management.

Managing a suite of funds and mandates, across both public and private investments, and spanning both debt and equity across diverse geographies and investment styles, we provide access to every aspect of real estate investing.

With over 80 years of real estate investing experience and more than 500 employees* located across over 20 cities throughout the United States, Europe and Asia Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise.

*Includes 285 real estate investment professionals, supported by over 250 Nuveen employees. Source: Nuveen, 30 September 2018.

Alice Breheny

Global Head of Research

With 20 years' experience in property research, Alice is Head of the Global Real Estate Research team. She manages a team who are devoted to researching the direct property market in Europe, the US and Asia.

Alice works alongside Austin Mitchell, Global Head of Business Development, jointly running the Research & Development (R&D) function, which ensures our research is applied and remains at the forefront of product development. The R&D team identifies global, structural trends and finds appropriate opportunities for real estate investors.

Alice is a member of the Property Investment Committee and the Global Product Committee, ensuring the research feeds into every stage of the investment process and product development. She is also a member of the Investment Property Forum, the Society of Property Researchers, INREV and the International Council of Shopping Centres.

Alice has a BA (Hons) degree in Geography from the University of Southampton.

Participants

Ankit Shah

Investment Manager

Ankit Shah is Investment Manager at Antares Managing Agency. In this role, he is responsible for structuring and implementing overall allocation of Investment portfolios for Antares, ranging from risk mitigation to capital optimised allocation strategies across asset classes as well as keeping it within regulatory and Solvency II framework.

Prior to joining the company, Ankit was working with Qatar Insurance Company, Doha, Qatar (parent of Antares) as Vice President – Investments, overseeing the investment operations and strategic asset allocation across the QIC group. Before this, he was Senior Fund Controller at AXA Investment Managers working on various UK and Pan European real estate funds and Group Financial Controller at UK Capital Investments Group. He trained as an Auditor and worked with Grant Thornton.

Ankit Holds a Bachelors in Accounting & Economics and is a Fellow at ACCA and Institute of Chartered Accountants of India.

Rebecca Davis, CFA

Investment Director, Pension Practice

Becca is an Investment Director at Cambridge Associates and is based in the London office. As a member of the European Pensions Practice, she helps manage multi-asset portfolios for public and private pension plans, either on a discretionary or advisory basis. In addition, she helps trustees set their long-term strategic goals and investment asset allocation policies, within an asset liability management framework.

Prior to joining Cambridge in 2017, she spent five years in the delegated investment services team at Willis Towers Watson, where she helped manage discretionary portfolios for UK defined benefit pension funds and advised trustees on their long-term investment strategy. In her final year, she was a member of the hedge fund portfolio management group which was responsible for managing an in-house fund of hedge funds and overseeing all discretionary hedge fund portfolios. Before joining the investment team, she worked in the executive compensation team for three years.

Participants

Casper Hammerich, CAIA

Principal

Casper is Principal at Kirstein and has been with the company since 2010. Casper is involved in all advisory related activities and is responsible for providing strategic and operational advisory to international asset management firms. Also, Casper is responsible for maintaining relationships with leading European asset owners, and for developing the firms' European advisory business.

Casper earned his B.Sc. and M.Sc. degrees at Copenhagen Business School and London School of Economics. Casper has held the CAIA charter since 2016.

Joanne Job

Managing Director

Joanne is a Managing Director and Head of Research. She is responsible for investment research, which includes manager search and selection, investment and operational due diligence and analytics across all asset classes. She is an alternative investment specialist, focusing on private markets and hedge funds. She is also an adviser.

Prior to joining MJ Hudson Allenbridge, Joanne spent five years in the Alternative Investments Group at Moody's Investors Service in London. She held lead analyst responsibilities for credit ratings of asset management companies, operational quality ratings of hedge funds, credit ratings of structured products securitised by fund of hedge fund portfolios and ratings of exchange-traded funds.

Before Moody's, Joanne worked for GlobeOp Financial Services, a hedge fund administrator, covering hedge funds based primarily in Europe. Joanne also held positions as Equity Analyst at ABN Amro Asia Securities, and as a Fund Manager covering US markets at Cirne International, a fund of funds based in Mauritius.

Joanne is a British Chevening Scholar. She is the London Beneficiary Selection Chair of 100 Women in Finance, a global non-for-profit organisation.

Participants

Reza Mahmud

Senior Investment Consultant

Reza represents PwC's Pensions Investment Consulting business, which focuses on Trustee and Corporate advice. He helped establish and is a member of PwC's multi-disciplinary Investment Committee (pensions, insurance, sovereign wealth funds, private wealth). Prior to PwC he was a multi-asset investment manager at Aviva Life and Pensions,and before that he served with Brunei's sovereign wealth fund as a portfolio manager and asset allocation analyst.

Reza has an LLB law degree from Exeter University and an Investment Management MSc from Cass Business School (City University). He has also studied behavioural finance and investments at Harvard University, University of Chicago Graduate School of Business, and London Business School, and studied Psychology and Cognitive Science at Johns Hopkins University.

Brendan Maton

Freelance Journalist

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles. Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

What's the Alternative?

CAMRADATA gathered a panel of investment managers, consultants and asset owners to discuss the attractiveness of illiquid alternative strategies. These ranged from City office blocks to Public Finance Initiatives to funding private equity buy-outs in the European mid-market.

Some of these opportunities are well-known to insurers, pension funds and family offices - real estate is often described as the original alternative. But following the Great Financial Crisis, new forms of debt are becoming available to investors that hitherto banks funded. The CAMRADATA panel began by trying to get a sense of the characteristics of these new forms and where they fit into portfolios at this stage in the credit cycle.

> "Because of cashflow concerns, UK DB pension funds have typically been more hesitant than some other European institutional investors - for example in the Nordics and the Netherlands - to adopt larger illiquid allocations and embrace emerging illiquid ideas"

Two and a half years ago the Qatar Insurance Company's London subsidiary, Antares, started looking at alternatives, hoping to find better yields for a small portion of its £600m assets. The search was truly open but breadth of choice did not necessarily help. "Once you start exploring, there are so many different types and sub-classes of alternatives out there," explains Ankit Shah, investment manager at QIC Global , the man responsible for allocation and manager selection.

The CAMRADATA panel agreed that illiquid alternatives are a pretty heterogeneous bunch and lumping them all in the same box probably doesn't help clarify their different natures. "We have been researching and recommending suitable illiquid alternative investments to our clients for over four decades" said Rebecca Davis, investment director at Cambridge Associates. But she added that because of cashflow concerns, UK DB pension funds have typically been more hesitant than some other European institutional investors - for example in the Nordics and the Netherlands - to adopt larger illiquid allocations and embrace emerging illiquid ideas. "Private credit as an institutional asset class emerged post-Global Financial Crisis, so early adoption by UK DB Plans is not altogether unsurprising," she said. "But education about how illiquid alternatives can fit within maturing pension plan portfolios is vital to ensure trustees consider the broadest opportunity set to help meet their objectives."

Reza Mahmud, a senior consultant at PwC, agreed. "There is so much going on for UK pension schemes that trustees need help to understand the benefits and challenges of the wide range of alternatives available. Alternatives are highly idiosyncratic investments and can be complex."

QIC Global is a group of companies in general insurance, not a pension fund. But Shah said that even for finance professionals who sit on the board of an insurance company, getting to grips with alternatives has been a steep learning curve. And because their illiquid nature means that from commitment to return of principal can be a period of up to thirty years for infrastructure investments, there is extra cause to scrutinise these opportunities thoroughly.

In the end, QIC Global split its allocation between Private Debt, a Value-Add European real estate fund and senior housing, accommodation specifically designed for older people in the US. The latter is not a well-known sub-sector for European investors and was initially unfamiliar to the London team. Its parent QIC in Doha, however, had previously made a commitment to the same specialist manager, so there was understanding and trust within the Group. The manager's track record was excellent too, so London committed to the second fund.

Alice Breheny, head of research for real estate manager, Nuveen, told the CAMRADATA panel that senior housing was an excellent way to play the ageing population theme. She said that Nuveen harnessed the power of fundamental, secular trends such as ageing and urbanisation to create portfolios and strategies for clients that were less volatile than the economic cycle.

Shah's anecdote touched upon many of the themes of selecting alternatives. The first was how to understand an unfamiliar strategy. Labels and associations do not always help; communication with trusted existing users of that strategy can. Joanne Job, head of research into alternative investments at investment consultancy, MJ Hudson Allenbridge, noted that the term "alternatives" has come to mean different things, compared to a few years ago when it primarily meant hedge funds

Murtaza Merchant, partner and head of financial optimisation at MV Credit, recalled that when his firm started in 2000, prospective investors struggled to categorise the investment opportunity into their own internal allocation buckets. MV provides loans to private-equity buy-outs of upper and mid-sized European companies. But some investors just homed in on the private equity aspect, which led to confusion because MV's returns, coming from debt, seemed less attractive than owning private equity per se.

"The term "alternatives" has come to mean different things, compared to a few years ago when it primarily meant hedge funds"

As the private debt market has both grown and become more familiar to pension funds and insurers, the challenge has shifted from internal classification to that of categorising the multiple categories of risk within Private Debt. A successful track record has greatly helped. Natixis Investment Managers recently acquired a majority stake in the firm, although it continues to operate as a stand-alone unit.

Adrian Jones, director of alternative assets at Allianz Global Investors, suggested that one obvious way to comprehend all illiquid alternatives was to see them as means to obtain cashflows. “An alternative mechanism is what we offer,” he told the CAMRADATA panel. “There is an illiquidity or complexity premium for infra debt.” Jones was phlegmatic about the attractions of any alternative offering. “If that spread ceases, then the rationale for this type of debt disappears and most investors should stop accessing it.”

> “Overcrowding is a major fear for investors today as the search for yield continues. The UK and European economies lag the US, while even there interest rates have only begun to rise from historic lows”

In answer to the question of whether asset owners lack education about alternatives, Jones said that there was plenty of material out there. “Those who want to educate themselves about these strategies will. Our clients understand what they are buying and what it does for them.”

He added that, to his mind, insurers were managing on a risk basis against Solvency II while Defined Benefit pension schemes were more viewing infra debt more as Absolute Return. He said it was important to understand not just how the asset class meets your organisation’s needs but also those of other investors, because that gives a sense of which pockets of the market are less crowded.

Mushrooming demand

Overcrowding is a major fear for investors today as the search for yield continues. The UK and European economies lag the US, while even there interest rates have only begun to rise from historic lows. This explains the mushrooming interest in alternatives but also the doubts that some investors will overpay to find a home for cash. The asset managers on the panel were asked whether they were worried by current conditions. Jones said a lot of term sheets out there for infra debt projects resembled those of 2007 – a worrying sign.

“And yet there is a lot of dry powder out there,” rejoined Caspar Hammerich, a principal at Copenhagen-based advisory firm, Kirstein.
“If we are late-cycle, what is your fall-back?” Job asked the managers at the roundtable. Merchant joked that we have been at the top of the cycle for two and a half years. He then said you can either take a general view on any credit class or asset category or you can do analysis on a firm’s own portfolio. He emphasised that MV concentrated on the underlying businesses to which it is exposed, while considering macro risk. “There is the European leveraged loan market. But within the constituent companies, there is a great difference between a small-cap, regionally-focussed French food producer on E10m EBITDA and the kind of area we hunt in, which are global businesses with E50-100m EBITDA. Investors struggle if they apply the same methodology to each and every enterprise. What we are interested in is ensuring cashflows from our borrowers’ businesses are sustained.”

Regarding dry powder, Merchant reported that MV has already deployed capital to 15 transactions for its just-closed subordinated fund, MV IV. “Because we have relationships with all the top private equity sponsors, we haven’t found it difficult to source opportunities.”

Bricks and Mortar

Regarding overcrowding and overvaluations, Breheny said there were major investors, including Sovereign Wealth Funds, still waiting on the sidelines rather than allocating to property at current prices. In a warning similar to Merchant’s, she urged investors to consider the characteristics of the various sub-classes of real estate available. “Buying a “core” portfolio of high-quality office blocks in the world’s richest cities or leading financial centres will not capture all the diversifying benefits,” she said. “If you buy a development that houses a blue-chip asset manager or investment bank, then you are taking on equity-related risk because the fortunes of those tenants are linked to equity markets.” Instead of relying on such obvious “core” types of asset, Breheny suggested a broader, more thematic approach. For example, Nuveen now offers a vehicle that offers the whole city, not merely The City. “We already have a European Cities Fund aimed at institutional investors; we have just launched an Asia-Pacific Cities Fund,” she told the CAMRADATA panel. But which conurbations get selected and which rejected? Breheny said Nuveen analysed trends such as inward migration because that is a good indicator of future prosperity.

> “If you buy a development that houses a blue-chip asset manager or investment bank, then you are taking on equity-related risk because the fortunes of those tenants are linked to equity markets”

“To many investors, real estate is often not considered as a “real” alternative investment,” said Hammerich. “With the perceived safety of cashflows from core real estate in particular, many investors will consider the asset class as a proxy for fixed income."

This is also one of the reasons why allocations to real estate are close to double digits with many Nordic investors.

Regarding private equity, Hammerich said the fact that virtually all investors today seek access to the best funds in the market while only a limited number of the largest pension funds will be of interest to these funds' managers, means club-deals and customised transactions that enable scalability have become a new norm in the market. This trend also applies for other types of real asset investments, such as renewable infrastructure. The fixed income analogy of real assets is quite straightforward to many, Hammerich noted, but also the fact that many investors increasingly perceive alternatives as a way of exercising ESG policies, for example via specific SDG targets.

> "Central to fiduciary duty is the need to identify and manage the issues that are expected to impact on the performance of our clients' investments - ESG issues are a critical part of this"

Jones noted that in the world of private deals, lenders could exert influence more readily than in public bond auctions. "When you move away from public markets, it is no longer the case that everyone is equal. As a private creditor, you can demand information in the negotiations. It's all about preparation and those clauses. In ESG, for example, you can ask for environmental impact assessments. In the public market, the prospectus is out there for scrutiny for five weeks and that is it."

Breheny said that Nuveen had to be sustainable because "central to fiduciary duty is the need to identify and manage the issues that are expected to impact on the performance of our clients' investments - ESG issues are a critical part of this." She explained that it is all very well for property investors in climate-vulnerable cities such as Miami having building insurance. "But if your tenant company's workforce has to leave the city for four or five days each year because of hurricanes, other risks come into focus."

Labour Pains

Mahmud then asked about populism and geopolitical risk, as these are on the rise in Europe and elsewhere. "How would a far-left government with inclinations for renationalisation affect deals in infrastructure?"

Jones responded that it wasn't Allianz Global Investors' role to predict what might happen but to plan for eventualities. "Change is a risk but we don't try to guess right."

He then gave the example of how Allianz GI evaluated the M8 extension in Scotland, which was funded as a Public Private Partnership prior to the referendum on independence in Scotland. "Some investors turned away because of the uncertainty," recalled Jones. "We asked what an independent Scotland might look like.

We compared it to a similar country which is already independent, Ireland, and decided that we would be ok participating in this deal because Ireland has a valuable relationship with the European Investment Bank, a fellow lender in the M8 deal and an institution Holyrood would have to deal with if it broke away from the UK." To make this link significant, Allianz GI and others insisted the deal was written as an international, not Scottish, one.

He nevertheless added that infra debt investors could not ignore geopolitical risk: "Some of these deals are for thirty years. That is longer than the term of the political administration that approved the deal; longer than the life of any closed fund that raised equity for the same deal."

Mahmud asked whether infra debt investors had to look further afield in order to find new opportunities. Jones replied that his fund does not look beyond Western Europe. He said Allianz GI would walk away rather than strike a deal at the wrong price. "The question for asset owners can often be how quickly their capital needs deployment. Some cannot wait; some – a minority - do not need the spread."

He gave the example of one client that overcommitted to infra debt, accounting for the extra as part of total fixed income exposure, in expectation that as opportunities arose in time, that allocation imbalance might revert. This could be deemed dynamic asset allocation. It is one way of managing the general market pressure of supply and demand. But Jones said in 2018 Allianz GI's deal acceptance was only one-third the volume of previous years. "Sectors such as greenfield construction are no longer attractive to us," he said. "If prices are too high and opportunities too few, the only variable left is to lower commitments."

Regarding relationships with sponsors, Jones said the important thing was to make a commitment decision quickly: "Sponsors do not like asset managers who take three months before they turn down a deal. We can make an initial decision in ten minutes." Both Allianz GI and MV cursorily reject more than three-quarters of the opportunities put before them.

"The question for asset owners can often be how quickly their capital needs deployment. Some cannot wait; some – a minority - do not need the spread"

Breaking covenants

Conversation then turned to the lightening of covenants in private-equity backed debt issuance. Previous CAMRADATA roundtables have concerned themselves with the dangers of the trend.

Merchant, however, suggested that the talk of covenants missed the biggest risks: “If you have breached covenants, it’s too late. I know it is fashionable now to talk about covenants but we care much more about EBITDA because we are a cashflow business. If a company downgrades its EBITDA or we see sponsors coming to market with pro forma EBITDA, that is what worries us.”

> “Private markets are not new to capitalism. Publicly-quoted companies are the novelty, appearing after centuries of private trade between merchants. We have come full circle”

Merchant added that MV cannot afford to lose principal. “Our losses over 18 years have been half the market average. That explains why we are top quartile. We monitor companies to make sure the business keeps running – and we get out of loans where necessary. Sometimes I think all the talk about covenants emanates from law firms, who are keen on demonstrating the value they add to sponsors.”

Flexibility in real estate during the current environment manifests itself in other ways. Breheny gave an example of how Nuveen recently renovated Devonshire Square in the City for WeWork. “In the past this kind of company would have been perceived as an enemy: tech versus traditional real estate. Now there is an alliance.” She said that Nuveen had to adapt to the culture of tech firms, which expect flexible, short-term leases. “WeWork pay us for 100% occupancy but they can prosper on 65% occupancy rates,” she said.

By region, Breheny gave the example of Italy, where Nuveen invests in only three cities. Rome and Milan are obvious choices but the third is… Bologna. “There is a lot of automotive industry (Ferrari is headquartered 20km down the road) plus a great university,” said Breheny. “So it’s a great domestically-focused diversifier.” She added that the counter-cyclical value of a mixed property portfolio made itself apparent through the cycle.

In conclusion

Private markets are not new to capitalism. Mahmud made the point that publicly-quoted companies are the novelty, appearing after centuries of private trade between merchants. “We have come full circle,” he said.
Shah then asked that if we see the benefits of lower volatility and higher returns from these types of investment, “what is the right weight to alternatives? Why 5% and not 20%?”
Needless to say, many on the panel agreed that 5% was an insufficient allocation. “Solvency II’s look-through approach allows for better treatment of private debt but not all insurance clients interpret Solvency II in the same way,” claimed Merchant.
The CAMRADATA panel agreed to meet again next year to discover whether allocations would indeed continue to rise.

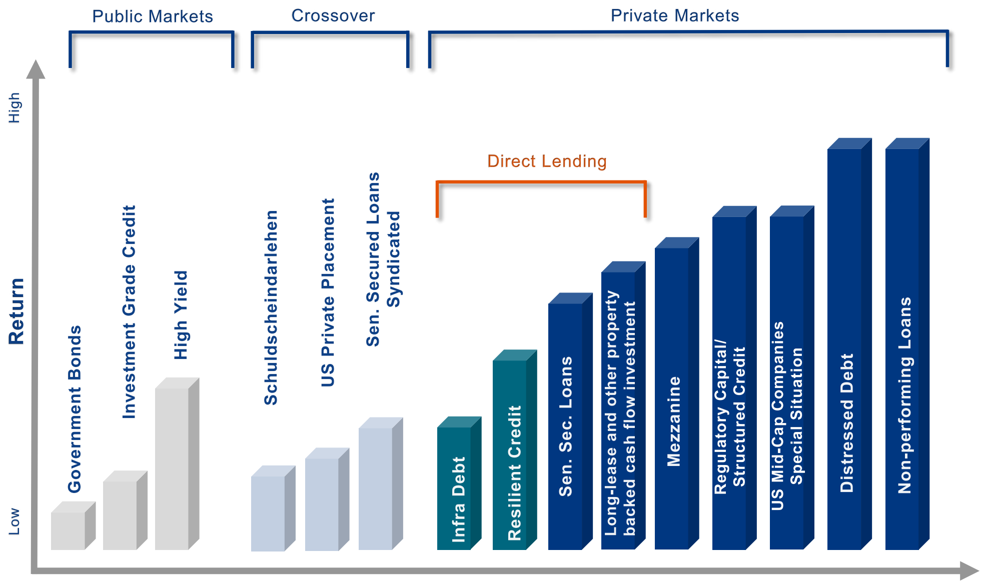
"Alternative" Assets' Mid-Life Crisis

As Alternatives mature will they deliver on youthful promises?

Allianz Global Investors

Somewhere between the ying of low return / low volatility traditional fixed income and the yang of high return / high volatility listed equity there is a promised Nirvana of positive real returns with modest volatility from a group of assets variously referred to as "real", "alternative" and "illiquids".

> Strategists predict that optimal pension fund allocations could increase from the currently common aspiration of c.5-7% to upwards of 12-15%, either as part of a de-risking driven shift from listed equities or in pursuit of greater alpha within the matching (i.e. largely fixed income) allocation



Source: Allianz Global Investors, 2018. The views and opinions expressed herein, which are subject to change without notice, are those of the issuer companies at the time of publication.

Enthusiasm for this nascent asset grouping seems to be at an all-time high. Strategists predict that optimal pension fund allocations could increase from the currently common aspiration of c.5-7% to upwards of 12-15%, either as part of a de-risking driven shift from listed equities or in pursuit of greater alpha within the matching (i.e. largely fixed income) allocation.

But investors have learned to be cautious about bold claims made regarding "new assets" and assurances that "this time it is different".

Today, with the benefit of hindsight, it seems incredible that a little over a decade ago respected US economic commentators and policy-makers, reflecting on the decline in US Federal borrowing and the explosion in the issuance of mortgage-backed securities ventured that, in the future, super senior tranches" of AAA mortgage securitisations would replace US Treasuries as the closest real-world proxy to a risk-free rate of return over which all other asset classes would be measured.

Before mocking, it is worth recalling that there was nothing intrinsically wrong with the idea of top-slicing one of the largest and hitherto most predictable consumer credit asset classes, and in so-doing disintermediating banks as they became ever more complicated and opaque to external investors (because of the banks' greater use of derivatives and the increase in bank absolute leverage ratios permitted by Basel II). Very few structured finance structures failed. What went wrong was that the characteristics of the assets upon which the structures were predicated changed fundamentally as demand exceeded natural supply and alignments of interest between asset originators and owners disappeared as originators who previously also held, realised they were now originating only to sell.

Fundamentally, many investors did not understand what they were buying and so were unable to distinguish the good from the bad or indeed recognise when the market had passed the point when there were any good assets. From that flowed the regulatory suspicion towards structured finance, which exists to this day, and the massive curtailment of a valuable engine for financing economic growth.

For me the structured finance experience of 2003-08 is a cautionary tale for alternative asset managers and investors of what happens when a good idea becomes distorted by lack of understanding and poor alignment of interests. We would do well to heed the lessons learnt or risk suffering the same fate – allowing the reckless actions of the few to damage the market for all.

It is worth noting that many of the 'new' opportunities badged loosely as alternative assets grew directly from the financial crisis. In Europe in particular, asset classes which had long been dominated by commercial banks became available to real money investors as these traditional intermediaries discovered their business models of aggregating and repackaging such assets had ceased to be viable.

Infrastructure debt is a good example. Before the financial crisis many pension funds and insurers saw little to excite them in the opportunity to invest directly in construction phase special purpose project companies. Relative spreads were low, many of the risks were unfamiliar and they lacked the specialist teams such investments require. However, in a post-crisis environment, replacing the financing banks with an alternative that did possess the requisite experience and networks to efficiently originate and manage such assets seemed attractive. Equally, government bonds offered adequate returns vs. perceived risk and many governments felt they had the borrowing capacity to fund infrastructure themselves.

What changed was that the cost of financing the intermediaries (banks and governments) increased relative to the cost of investing directly. The novelty was not the underlying asset class only its route to market.

Did banks under-price project finance risk pre-crisis? Did the recipients of much higher spreads available to investors immediately following the crisis mistake a temporary global liquidity shortage for the real value of their provision of liquidity to idiosyncratic, but fundamentally low risk, assets?

The mistake each participant potentially makes is to assume a current state is the normal state.

Pre-crisis, bank liquidity was cheap. Bank liquidity did not become more expensive because of losses to project finance assets. When mortgage lending and derivative losses (and general loss of confidence in banking) occurred, bank project financing at prevailing terms and margins became unsustainable, and a market that had hitherto been insufficiently attractive for agile investors and managers to commit resources to suddenly became attractive.

The flood into infrastructure of late adopters and the resurgence of bank lending (the return to the - depending on your perspective - bad old habit, or accepted market practice of funding short to finance long is back) has driven infrastructure debt spreads lower.

As a manager of 'illiquid' assets my job is to prevent my investors sacrificing liquidity without gaining something they value in return: an adequate illiquidity premium, greater diversity, lower volatility through greater control…and ideally a combination of all three. Investors who find illiquidity (or novelty / complexity) premia of new assets, among the types of alternatives they have bought to date, are now too low, and they need to decide whether this is just a cyclical phenomenon (liquidity) or secular (novelty) and if the latter move on to new alternative assets.

Whether an investor is correct to hold a portfolio of alternative assets exhibiting return and volatility characteristics mid-way between traditional fixed income and listed equity depends not only on the timing of the market cycle but critically its own situation.

“When mortgage lending and derivative losses (and general loss of confidence in banking) occurred, bank project financing at prevailing terms and margins became unsustainable, and a market that had hitherto been insufficiently attractive for agile investors and managers to commit resources to suddenly became attractive”

A pension fund in deficit should experience a larger fall in the value of its liabilities than in its portfolio of alternative quasi-fixed-income assets in a rising interest rate environment. Additionally, valuation differences and preferences between various alternative investments are investor-specific.

Finally, even if your optimal strategic allocation at any point in the cycle is knowable there is the problem of deployment. The array of “alternative assets” is vast and increasing, and just as investors understand an asset class their peers pile-in and frustrate their deployment. But there again is failure to deploy actually a failure? If your strategy puts a value on liquidity which the market cannot currently satisfy then the market is doing its job – telling you to stay liquid until it can deliver the illiquidity premium you need. Provided of course your manager is acting in your best interests and you do understand what you are buying (or often what is being bought on your behalf). A high spread on an unfamiliar asset which is hard to sell is not always an “illiquidity spread”, sometimes it is just the correct price of higher volatility / risk.

“If your strategy puts a value on liquidity which the market cannot currently satisfy then the market is doing its job – telling you to stay liquid until it can deliver the illiquidity premium you need”

Written by

Adrian Jones

Director, Alternative Assets, Allianz Global Investors

Hungry for yield: private debt investing, with a twist

MV|Credit

> Investing in loans to private equity-owned companies provides a level of safety: in times of trouble, the owner typically has the financial muscle to step in and provide financing or know-how to help fix problems

The search for yield is relentless. The days of meaningful yield from sovereign debt and blue chip bonds are long gone. The search continues elsewhere.

But achieving higher yields than a long-only bond strategy while keeping risks in check is tougher than ever. For many investors, the range of viable options is narrowing, as their fears increase of both a downturn and rising inflation.

One of the solutions is investing in private debt and, specifically, leveraged loans. If the loans are senior and issued by non-cyclical companies with diversified sales channels, the risks presented by a downturn are strongly mitigated. If the companies are, in addition, owned by reputable and financially-strong private equity firms, the risks are further mitigated. And, because leveraged loans have floating interest rates, the risks presented by rising inflation can be offset too.

No investment strategy is recession-proof or fully resistant to inflation. But MV Credit believes a strategy which incorporates the elements above ought to provide superior yields on debt with relatively low risk.

Why leveraged loans?

Leveraged loans historically have provided the best risk-return profile across the debt investment landscape. They outperform senior corporate debt, high yield, REITS and infrastructure debt in terms of returns balanced against volatility. That's to say, they have more consistent, predictable performance.

Investing in loans to private equity-owned companies provides a level of safety: in times of trouble, the owner typically has the financial muscle to step in and provide financing or know-how to help fix problems.

Within the leveraged loans spectrum MV Credit, an affiliate of Natixis Investment Managers, invests across the entire capital structure. The spread above investment grade fixed income is some 300bps to 500bps, meaning higher potential returns from senior leveraged loans.

Leveraged loans are also issued with floating rates, which rise and fall with inflation and interest rates, while the average loan to value of senior leveraged loans is still attractive, providing a cushion against falling prices in difficult markets.

The twin firewalls: credit selection and monitoring

Downside protection underpins the strategy from start to finish. "Losses are an inevitable part of investing, just as taxes are inevitable for us all," says Rafael Calvo, managing partner, of MV Credit. "The key is minimising these losses, and that's what we prioritise."

The concept of loss minimisation is translated into action through two firewalls: credit selection and intense monitoring. These twin firewalls enabled MV Credit's clients to get through both the financial crisis and the euro crisis in much better shape than comparable debt strategies. "We are credit people, we can smell good credits and bad credits. We also have grey hair in abundance," says Calvo.

However, he is alive to the dangers of over-confidence in credit selection, which is why the second firewall, monitoring, exists. Early-warning systems aim to identify risky borrowers six to nine months before they face serious problems, enabling an orderly exit from investments. The creation of a divestment committee for underperforming credits enables exits at still-attractive prices.

The monitoring team's duty is to gather information, to highlight transactions performing below expectations and finally to call for divestment committees. This team independence is critical – at many firms, investment and divestment decisions are taken by the same groups without relying in an unbiased judgment. The problem with this is that the passion required to argue for the inclusion of an asset in the portfolio can blind the analyst to problems as they arise.

And the monitoring process permeates the MV Credit investment ranks. “Once we invest in companies we adopt a healthy paranoia mentality,” says Calvo.

Focus on less-cyclical businesses

The safety-first approach leads MV Credit to companies that are less exposed to economic cycles and to larger companies that have diversified customer bases.

The length and amplitude of economic cycles are not predictable, whatever economists say. To achieve consistent returns from debt strategies, less cyclical businesses are preferable. “We don’t want to be constantly thinking about risk-on, risk-off,” says Calvo. “We want to sleep at night. Every time we make a decision, we consider whether the company could withstand a downturn tomorrow.”

Less cyclical companies include healthcare businesses that sell non-discretionary products and software companies with strong subscription services, which are relatively immune to economic cycles.

Meanwhile, investing in companies with gross annual earnings of more than €30m reduces the risk of default, because these companies tend to book sales right across the world and across customer segments. This offers strong diversification effects to the portfolio.

> “Investing in companies with gross annual earnings of more than €30m reduces the risk of default, because these companies tend to book sales right across the world and across customer segments. This offers strong diversification effects to the portfolio”

Sourcing deals takes skill and reputation

There are a number of investment firms attracted to leveraged loans because of the excess risk-return available. But this return is only available to firms with experience of the segment, understanding of the complexity of the transactions, and years of working as a team to unearth and share relevant information.

Founded in 2000, MV Credit is dedicated solely to European credit, financing over €5.3bn in over 500 transactions since it launched. It is now one of the longest-established credit management teams in the industry. “We have stayed together through good and bad, seen many different credit cycles,” says Calvo. “Focusing on one segment only gives us depth and perspective.”

This perspective is also helpful in sourcing deals. The best value from leveraged loans is available by sourcing deals directly, which means establishing a reputation within the loans network and maintaining it through frequent transactions and professional behaviour.

Who’s the strategy for?

A senior leveraged loans strategy is suitable for all investors hungry for yield and seeking to diversify their portfolios.

Many pension funds, insurance companies, sovereign wealth funds and family offices invested heavily in government bonds 10-15 years ago when yields were attractive. Those bonds have reached or are reaching maturity now and need replacing. Cash is not an option.

Leveraged loans provide good returns per unit of risk in return for an illiquidity premium. Unlike private equity strategies, the J-curve is very shallow and interest payments start soon after an investment is made. And unlike many private equity and distressed debt strategies, committed capital can be put to work quickly, even if the commitment is sizeable.

In terms of its place in the portfolio, a leveraged loans strategy typically resides in the alternative segment or within the fixed income allocation.

Current outlook for the strategy

The strategy provides strong returns when the economy is weaker and refinancing is required, but also vibrant performance when the economy is strong and M&A activity is buoyant.

In addition, private equity sponsors have sweated their assets harder since the financial crisis, ensuring that portfolio companies are able to navigate both rising and falling markets. Private equity firms are refining business models, building business platforms and leveraging ideas and resources across their portfolios. The entire private equity-owned market is healthier as a result.

Conclusion

A leveraged loan strategy focused on diversified companies, which are not highly exposed to the vagaries of markets, can help yield-seeking investors sleep at night. Partnering with a team which has managed assets through the most difficult markets in living memory should give investors more comfort about the sustainability of their debt portfolios.

Written on 8 November 2018

> "Partnering with a team which has managed assets through the most difficult markets in living memory should give investors more comfort about the sustainability of their debt portfolios"

Written by

Rafa Calvo

Managing Partner,
Head of Senior Strategies,
Co-Head Origination

The impact of megatrends

and picking tomorrow's best cities

nuveen
REAL ESTATE

Global megatrends are re-shaping the world economic order. From mass urbanisation, to the rise of the global middle classes, aging populations, technological trends and the shift of economic power from the West to the emerging world, all pose major implications for the built environment and the long run demand for real estate.

At Nuveen, we are considering megatrends in both defensive and offensive strategies for our clients. We carry out in-depth research in order to determine the best way to capture long-term, structural changes in both occupational demand and capital flows, to create sustainable real estate products relevant to occupiers and investors, whilst future-proofing our clients' interests.

> "Real estate fundamentals are expected to remain solid in 2019, despite the market's late cycle, rising interest rates and structural change disrupting the industry, most notably the retail sector"

By definition, these megatrends are multi-jurisdictional but the consequences could be quite local in nature. As such, our top-down analysis is focused on cities rather than countries. We believe that the impact of megatrends at a city level is fundamental to delivering performance to clients in an increasingly crowded global real estate market.

We use a proprietary research process to identify the top 2% of global cities. This methodical and balanced approach takes into account a wide range of characteristics: scale, transparency, stability and most importantly, structural megatrends, helping to future-proof a portfolio for long-term relevance and growth. Traditional structural measures of specific real estate risk must not be overlooked, so potential city targets must also score adequately against liquidity, transparency, and income security measures. This is why institutional investors often struggle to access opportunities in emerging world cities, where megatrends are producing dramatic impacts and leading to an explosion in new consumer markets. In developed world cities, where real estate risk is more palatable, the emphasis should be on cities which have the ability to attract talent, tourism and international tenants.

Overlaying and complementing our cities strategy is a clear tactical understanding of market fundamentals, which aims to deliver alpha to a portfolio at different points of the cycle. This involves a broader appreciation of sector dynamics across the whole city, as well as a deep dive into sub-market conditions to supplement our house view of the broader economic and capital market environment.

When constructing a portfolio, the benefits of diversification, whether location, sector or demand drivers, should also be at the forefront of any acquisition strategy. Common sense might suggest that we would bias our portfolios towards opportunities in Tier 1 cities. However, as investors, we also want to maximise the benefits of diversification in terms of location, sector and drivers of demand. The largest real estate markets - such as London and Paris - are typically closely-correlated, as they are driven by financial and business services. This means that they do not provide the normal benefits of geographical diversification. A balance of occupiers by industry type helps lower the volatility of growth and void risk; investments underpinned by financial and business services, for example, might be complemented with investments in resource or technology-led cities.

The focus on long term demographic, social and environmental trends does not mean the timing entry and exit points and asset management initiatives are not also critical factors in day-to-day portfolio management decisions: Although the universe of "winning" cities based on long run fundamentals might not change very much, short to medium term buy and/or sell priorities will inevitably evolve to reflect the cycle and enhance performance:

Our 2019 Outlook:

Real estate fundamentals are expected to remain solid in 2019, despite the market's late cycle, rising interest rates and structural change disrupting the industry, most notably the retail sector. Positive global growth forecasts and an overall balance of supply and demand continue to support net operating income and property values. Commercial real estate continues to attract new capital, with stable income returns generally exceeding those available in fixed income. However, little or no capital appreciation can be expected, and putting new capital to work will be challenging in 2019.

Structural change driven by demographics, technology and consumer trends are creating opportunities to add alpha. We expect global cities benefiting from advanced technology, sustainable development and rising urbanisation to outperform through the next market cycle. The upheavals impacting office and retail are generating demand for high-tech buildings with flexible office space and light industrial warehouses. We believe some of the best opportunities exist in alternative sectors, such as data centres, purpose-built student housing or manufactured housing.

Residential apartments globally are benefiting from strong demand among middle-income families and millennials priced out of home ownership. Global real estate debt's stable income returns and lower volatility offer risk protection for real estate equity portfolios.

US

The US economy and labour markets have been growing robustly in 2018 due to the tax cuts and fiscal stimulus passed at the end of 2017. With unemployment at its lowest rate for a decade, consumer confidence is at its highest level for 18 years. This provides a sound foundation entering 2019, with GDP growth forecast to be 2.6% for the year. Rising interest rates have not slowed real estate investment volumes, and with solid fundamentals in place - a healthy demand supply balance - we expect the yield cycle to last another year. However, we don't anticipate any yield compression in 2019 with returns being largely driven by income. We expect the structurally driven sectors of logistics and apartments - underpinned by ecommerce and demographics, respectively – to outperform. Office and retail, to a greater extent, are likely to fall further out of favour during the course of the year.

Europe

Political uncertainty and rising trade tensions are undermining exports and investment, and will temper near-term output. Jittery financial markets are illustrative of widespread political uncertainty, particularly in the UK and Italy.

Yield compression has come to an end in Europe and while we don't expect an imminent yield softening, there will be no additional support from capital markets. Real estate capital values may still rise further in 2019 due to the persistent rental cycle, albeit at a somewhat slower pace compared to 2018.

Logistics is set to be the best performing mainstream sector with healthy rental growth and even some further yield shift driving returns in 2019. However, it will be non-established sectors such as student housing or other sub-sectors in the living space, which are poised to perform best overall. These sectors are supported by new technology and demographics, as well as first mover advantages for investors which already have exposure to these segments.

Asia Pacific

Among the developed Asia Pacific economies, Australia and Japan are expected to be the stand-out performers in 2019. Positive demographic dividends and more diversified growth are expected to continue driving an uninterrupted economic expansion in Australia. Similarly, the positive pass-through from Abenomics will likely continue strengthening the investment and consumption outlook in Japan, on top of ongoing stimulus from very supportive monetary and financial conditions. On the other hand, the more open and financial services dependent economies such as Hong Kong and Singapore may face more uneven growth prospects from a less certain manufacturing and export outlook. Overall, expect slower but still resilient economic growth across Asia Pacific, by virtue of still relatively more accommodative monetary policy.

Over the short-term, we anticipate the under-rented, principal cities of Sydney, Brisbane and Tokyo to deliver the best risk-adjusted returns. Tokyo particularly will continue to benefit from the boost to domestic demand in the run up to the Olympics and associated infrastructure investment and, in turn, underscoring the already positive occupier outlook.

"Yield compression has come to an end in Europe and while we don't expect an imminent yield softening, there will be no additional support from capital markets. Real estate capital values may still rise further in 2019 due to the persistent rental cycle, albeit also at a somewhat slower pace compared to 2018"

Written by

Alice Breheny

Global Head of Research,
Nuveen Real Estate

CAMRADATA
5th Floor, 80 Leadenhall Street,
London, EC3A 3DH

+44 (0)20 3327 5600
camradata.com

Join us on LinkedIn

Important Notice

This document is produced by CAMRADATA Analytical Services Ltd ('CAMRADATA'), a company registered in England & Wales with registration number 06651543. CAMRADATA is neither authorised nor regulated by the Financial Conduct Authority in the United Kingdom nor the Securities and Exchange Commission in the United States of America.

This document is not intended to constitute an invitation or an inducement to engage in any investment activity. It is not intended to constitute investment advice and should not be relied upon as such. It is not intended and none of CAMRADATA, its holding companies or any of its or their associates ('CAMRADATA Group') shall have any liability whatsoever for (a) investment advice; (b) a recommendation to enter into any transaction or strategy; (c) advice that a transaction or strategy is suitable or appropriate; (d) the primary basis for any investment decision; (e) a representation, warranty, guarantee with respect to the legal, accounting, tax or other implications of any transaction or strategy; or (f) to cause the CAMRADATA Group to be an advisor or fiduciary of any recipient of this report or other third party.

The content and graphical illustrations contained in this document are provided for information purposes and should not be relied upon to form any investment decisions or to predict future performance. CAMRADATA recommends that recipients seek appropriate professional advice before making any investment decision.

Although the information expressed is provided in good faith, the CAMRADATA Group does not represent, warrant or guarantee that such information is accurate, complete or appropriate for your purposes and none of them shall be responsible for or have any liability to you for losses or damages (whether consequential, incidental or otherwise) arising in any way for errors or omissions in, or the use of or reliance upon the information contained in this document. To the greatest extent permitted by law, we exclude all conditions and warranties that might otherwise be implied by law with respect to the document, whether by operation of law, statute or otherwise, including as to their accuracy, completeness or fitness for purpose.