HYMANS ROBERTSON

Investment Perspectives

February 2024

Welcome to our February 2024 edition of Investment Perspectives

In our first edition this year, we've brought you the big themes in DB schemes, private markets and responsible investing. You'll also find a handpicked selection of our latest thought leadership. We hope you enjoy reading it, and we'd relish the opportunity to discuss these topics in more detail.

The key themes for DB investors in 2024

First up, Elaine Torry explores the following themes and their implications for DB investors:

- The impact of changing interest rates and inflation
- Setting an endgame that's right for you
- Productive finance and its relevance to DB schemes
- Ensuring income portfolios remain fit for purpose
- Managing illiquid assets

Achieving sustainability in buy-and-maintain credit

Jaid Longmore and David Watson profile buy-and-maintain credit, explaining why it's a good vehicle for sustainable investment.

What are the prospects for private markets in 2024?

It's widely thought that interest rates have peaked, opening the door for rate cuts in 2024. Linda McAleer and Penny Cochrane discuss the implications for private markets asset classes, in particular:

- decisions around **core UK commercial property** allocations
- the relative attractiveness of **debt over equity** across private markets
- the growth of interest in **natural capital** investment opportunities.

Capital markets update

Chris Arcari, Head of Capital Markets, presents his views on recent market movements and the outlook for each asset class.

RI in 2024: focusing on what matters

Last but not least, Simon Jones and Mhairi Gooch explain our new model of RI consulting, alongside the themes we'll be focusing on this year.

Contacting us

As ever, our team of investment consultants is eager to support you. Please get in touch for a one-to-one conversation on any of these topics.

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The key themes for DB investors in 2024

What should trustees focus on in 2024?

Well, last year proved to be busy and eventful for the pensions world – a state of affairs we're all becoming accustomed to! Market conditions proved challenging as schemes looked to rebalance, refine and, in some cases, completely revise their investment strategies to reflect improved funding positions.

But markets weren't the only factor for trustees to contend with. The Chancellor's Mansion House speech and Autumn Statement included some potentially sea-changing policies and reforms for the UK economy, and UK DB pension schemes have a part to play. It's against this changing regulatory and economic backdrop that I've outlined what I believe to be the key themes for pension schemes to focus on in 2024.

THEME 1:
The impact of changing interest rates and inflation

First up, let's consider the outlook for inflation and interest rates. We saw inflation fall in the fourth quarter of 2023, bringing expectations that interest-rate cuts were on the cards. Bond yields fell too, before retracing some of their steps in late 2023 and early 2024. Consequently, collateral positions for many schemes will have experienced some market-driven movement towards the end of 2023 and into 2024.

For trustees, it's important to have a robust framework in place to manage collateral. As well as ensuring collateral is sufficient to meet collateral calls, your framework should include plans on how to manage and redeploy excess collateral. Should it be held in cash? Should it be reinvested in another asset class? Or should it be used to de-lever and purchase physical bonds? Where there's deemed to be excess collateral, it's also important to consider the appropriateness of the liquidity arrangements across the wider investment strategy.

As we've seen already in 2024, movements in rates and inflation can have offsetting impacts on collateral. It's therefore important to acknowledge and reflect this in any collateral and liquidity monitoring arrangements. Movements in rates and inflation aren't perfectly correlated with each other in terms of timing and amount either, which can have material implications for liquidity and collateral calls.

KEY AREAS FOR TRUSTEES TO CONSIDER

Are your collateral and liquidity management arrangements sufficiently comprehensive to capture:

- Both raising of collateral and deployment of excess collateral?
- The impact on collateral from the imperfect correlation between rates and inflation, both in terms of the size of the impact and the timing on collateral pools.

THEME 2:

Setting an endgame that's right for you

Many schemes have seen their funding positions meaningfully improve over the last 12–18 months, and so endgame planning is already a key topic of conversation for trustees. However, a piece missing from this good news story is that the improvement in a scheme's funding position can only truly be assessed when it's considered relative to your endgame objective/long-term target.

It's therefore vital for trustees to discuss what to aim for – the three main options being an insurance solution, run off or consolidation – to inform what to do with the investment strategy now and how that might change over time. In the absence of this discussion or having a clear target, decisions around investment strategy are made in isolation. This can, in turn, lead to:

- de-risking taking place too quickly and re-risking being required at a later date
- risk being left on the table for too long and value being eroded
- unnecessary transaction costs being incurred, which are essentially a tax on scheme assets
- the scheme's assets dictating the timeframe for actioning strategic decisions

KEY AREAS FOR TRUSTEES TO CONSIDER

Trustees should therefore:

- Set aside time to refine their endgame target. If this is undecided, then ensure there's sufficient flexibility in the strategy to pivot at a future point.
- Engage with all the key stakeholders, most notably the scheme sponsor, to ensure that views and thinking are aligned, and that the implications of investment-strategy decisions are clearly understood.

THEME 3:
Productive finance and its relevance to DB schemes

Last year, central government was clear about its goal to unlock pension scheme capital to benefit the UK economy. So, the third theme is productive finance: understanding what it really means for your scheme, how quickly it can be accessed/invested in, and the extent to which costs are outweighed by improved risk-adjusted returns.

At the time of writing, there's no definitive description of which assets are classed as productive finance assets. However, there's general consensus that these are likely to include illiquid assets – for example, infrastructure and private equity, as well as higher-risk/higher-expected-return opportunities in the business start-up space.

While the industry awaits further clarity on this, a few observations on the appropriateness of productive finance include:

1. For schemes targeting buy-out, the investment strategy should align with your buy-out timeframe, which means liquidity and alignment with insurer pricing are both key considerations in whether to invest in productive finance.
2. For schemes that are looking to run on, key questions for trustees include whether they're looking to close a funding gap, build a surplus to subsidise future benefits or even fund other benefits, or refund a surplus back to the sponsor.
3. The maturity profile of a pension scheme will drive its need for liquidity, so a highly cashflow-negative scheme would need to consider the term structure and lock-up period associated with an investment in productive finance assets.

As it stands today, the concept of productive finance is likely to gain traction most quickly and meaningfully with open schemes that have long time horizons and are looking to generate high returns.

KEY AREAS FOR TRUSTEES TO CONSIDER

Trustees should consider the following when thinking about the appropriateness of productive finance:

- Alignment of the investment characteristics of productive finance with the scheme's long-term target/endgame.
- Alignment of the liquidity characteristics of productive finance with the liquidity needs of the scheme.
- Ultimately, what hasn't changed for trustees is the importance of setting a strategy based on the endgame objective they've deemed to be in the best interests of securing members' promised benefits. To that end, trustees should be mindful of this in any discussions around productive finance.

THEME 4:
Fit for purpose income portfolios

We've spoken before about how schemes are maturing, and cash outflow is becoming increasingly material. It won't be news to anyone that both asset and liability values have reduced over the last 12–18 months. This has knock-on implications for cashflow management that shouldn't be ignored. For example:

- The pensioner payroll will, for many schemes, now be a much higher proportion of asset values, which means minimising the need for forced selling of assets – especially fixed income assets before they reach maturity – is an increasingly important consideration.
- Now that funding positions are much improved, the cashflow coming through in the form of deficit-reduction contributions is likely to reduce.

In other words, cash outflow in pound terms hasn't reduced. But a primary source of cash inflow may be reduced – or even turned off completely.

The above shift in the balance of cashflow into and out of most schemes has led me to add this to the list of themes for this year. Most schemes now take income, alongside contributions, from some of their assets to help meet those cashflow needs – either in a structured or unstructured way. However, given this shift in relative importance of cashflow, this fourth key theme encourages trustees to consider evolving their income allocations while recognising the need for reliable, stable and liquid sources of income across a diversified stream of assets.

KEY AREAS FOR TRUSTEES TO CONSIDER

- How the cashflow needs have evolved.
- The extent to which the income profile of the assets has changed, both in absolute terms and relative to the liabilities.
- The relative reliance on contributions to do the heavy lifting.
- The extent to which buy-ins are doing the cashflow job, and what the implications are for other assets.
- The degree of forced-seller risk and whether that has evolved (eg because deficit reduction contributions have reduced/ceased) or if there's reinvestment risk that wasn't there before (eg because buy-ins are now covering near-term cashflow needs).
- Engage with all the key stakeholders, most notably the scheme sponsor, to ensure that views and thinking are aligned, and that the implications of investment-strategy decisions are clearly understood.

THEME 5:
Managing illiquid assets

As your endgame approaches, you'll need a plan for managing the exit from illiquid assets. In many cases, this will simply take the form of 'running off' the assets naturally. But we've seen the lifespan of many closed-ended illiquid funds extend, often for several years, so it's important to build these contingencies in, especially when planning for buy-out. Other illiquid assets that aren't in closed funds can be exited eg property. It's important to consider whether a plan is required to manage an exit from these assets, to avoid having to sell a significant allocation at a time when it may not be easy to do so.

However, it's not just managing an exit strategy for illiquid assets that's important. For schemes that want to run on, managing to a target allocation is also critical to effectively future-proof the scheme. For example, the right time to top up an allocation to illiquids and how comfortable are you with running an under or overweight to illiquid assets are both areas to address in the plan.

KEY AREAS FOR TRUSTEES TO CONSIDER

Key areas for trustees to consider in relation to their illiquid asset allocation include:

- Understanding the liquidity profile of the current asset allocation and how that might change due to prepayment, extensions, gating on funds etc.
- Consider how much liquidity is required now, and how does that evolve over the short, medium and longer term.
- Make a plan to manage and unwind illiquid assets as the need for liquidity grows. This can't be done overnight without risking material haircuts to asset values, so how can you get ahead of the game?

To find out more, please do reach out to me or your usual Hymans Robertson contacts.

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Achieving sustainability in buy-and-maintain credit

We believe buy-and-maintain credit lends itself well to sustainable investment. In this article, we explore how we approach sustainability in buy-and-maintain mandates.

De-risking schemes eye fixed income

Higher interest rates mean that many defined benefit (DB) pension schemes find themselves in stronger funding positions. Meanwhile, the prospective yields offered by fixed income assets look increasingly attractive to investors. As these schemes look to de-risk assets, with many targeting buy-out, allocations to fixed income have increased, particularly to investment-grade credit markets.

The need for stable, predictable cashflows that can be relied upon to meet the cash outflow from the scheme makes investment-grade credit a natural fit. For schemes targeting buy-out, it also offers the advantage of being well aligned with insurer pricing, thereby minimising the volatility between the scheme's funding position relative to what an insurer will charge to take on the liabilities.

What is buy-and-maintain credit?

Buy and maintain is a low-turnover approach to accessing investment-grade credit markets, compared with traditional passive and active approaches. Bonds in these portfolios are typically purchased to be held until maturity, thereby offering predictable cashflows, but they're continually managed to reflect the manager's ongoing credit analysis. Therefore, constructing a buy-and-maintain portfolio requires the manager to undertake significant fundamental credit research to initially choose (buy) and continually monitor (maintain) each security from a credit-risk perspective.

Bringing in sustainability

At the same time, the typically long-term, low-turnover nature of these portfolios makes sustainability considerations even more critical, as portfolios are more susceptible to the long-term risks associated with sustainability issues, such as climate change. These characteristics also better position managers to engage over the long term, enabling real-world outcomes. Consequently, we believe buy and maintain lends itself well to sustainable investment.

Sustainable buy-and-maintain credit

Responsible investment practices fit well in a buy-and-maintain approach, because it's research intensive and focused on risk management. In practical terms, the incorporation of environmental, social and governance (ESG) considerations within the manager's investment process should be beneficial, by reducing the risk of downgrades or defaults resulting from companies' bad ESG practices. We view ESG integration as a crucial component of the fundamental assessment of an issuer and think it should be considered in all buy-and-maintain approaches.

Our market research has found that while most investment managers are able to evidence the integration of ESG considerations into their fundamental assessment of an issuer's quality, fewer are able to demonstrate a clear sustainable objective. This only accounts for the consideration and mitigation of material risk, which, while important, does not contribute to a tangible sustainable outcome.

Quantifying sustainability

To be considered as a credible sustainable product, there must be a clear sustainable objective, which should form part of the fund's overall investment objective. There should be transparency around the approach and the expected sustainable outcome. While the focus might be on a single environmental or social issue, we believe consideration should be given to the range of environmental and social issues, to ensure that trade-offs are properly acknowledged. In addition, investments shouldn't have a net negative impact on society or the environment when pursuing the sustainable objective.

One example of a sustainable objective achievable within buy-and-maintain portfolios is a focus on climate. This might be reflected by putting net zero targets in place for the portfolio, introducing a decarbonisation mechanism to improve the portfolio's alignment over time and through active engagement with companies in the portfolio.

Targeting a sustainable outcome

Targeting climate-related objectives is not the only way in which managers can align with a sustainable objective. For example, managers might 'tilt' towards issuers who contribute positively to a chosen sustainable outcome. There are multiple ways managers might achieve this, including using proprietary ESG ratings to tilt towards higher-rated issuers or issuers that contribute to sustainable outcomes, or through alignment with external standards such as the UN Sustainable Development Goals (SDGs). We'd prefer this tilt to contribute to a positive sustainable outcome, and for this to be predefined and measurable.

Finally, when thinking about the sustainable objective of a buy-and-maintain mandate, it's important to consider what's practically achievable by the asset class. Given buy-and-maintain strategies purchase bonds with the expectation of holding them to maturity, typically with a large number of holdings to increase diversification, it wouldn't be conducive to adopt sustainability themes that are overly restrictive and constrain the portfolio, as this would introduce concentration risk.

In thinking about the credibility of a buy-and-maintain mandate's sustainable objective, proper scrutiny of the investment manager's methodology and data sources, reporting and stewardship capabilities should be undertaken. You'll find more detail on our thinking about best practice in these areas in our blog on Sustainable Investing.

Next steps

When thinking about sustainability in your buy-and-maintain portfolio, why not start by considering these two questions:

- Does the portfolio have a clearly defined sustainable objective (over and above integrating ESG considerations)?
- Does the investment manager have the stewardship structures and resources to achieve this sustainable objective (either through an engagement programme or sustainability research expertise)?

To find out more about sustainability in fixed income, speak to your usual contact at Hymans Robertson.

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What are the prospects for private markets in 2024?

With 2023 in the rearview mirror, there are widespread market expectations that interest rates have peaked, opening the door for rate cuts in 2024. This will have implications across private markets asset classes. In this article, we highlight three areas of focus for clients exploring private markets in 2024. These are:

- decisions around core UK commercial property allocations
- the relative attractiveness of debt over equity across private markets
- the growth of interest in natural capital investment opportunities.

A recap of 2023

Higher interest rates have made it more difficult for investors in private markets, many of whom rely on leverage to achieve their target returns. And leverage is also harder to find, as banks have been scaling back their lending activities across the board.

2023 was a tough year for new fundraising across private markets. This was due to several factors, including the relative attractiveness of other, more liquid asset classes that had repriced more quickly, and investors' reduced appetite for illiquidity. Clients were more capital constrained, receiving fewer distributions from existing allocations and having less space to make new allocations. This was down to the continuation of the denominator effect we saw in 2022 (illiquid assets becoming too big a proportion of overall assets as a result of market moves) and M&A activity levels dropping dramatically across private markets.

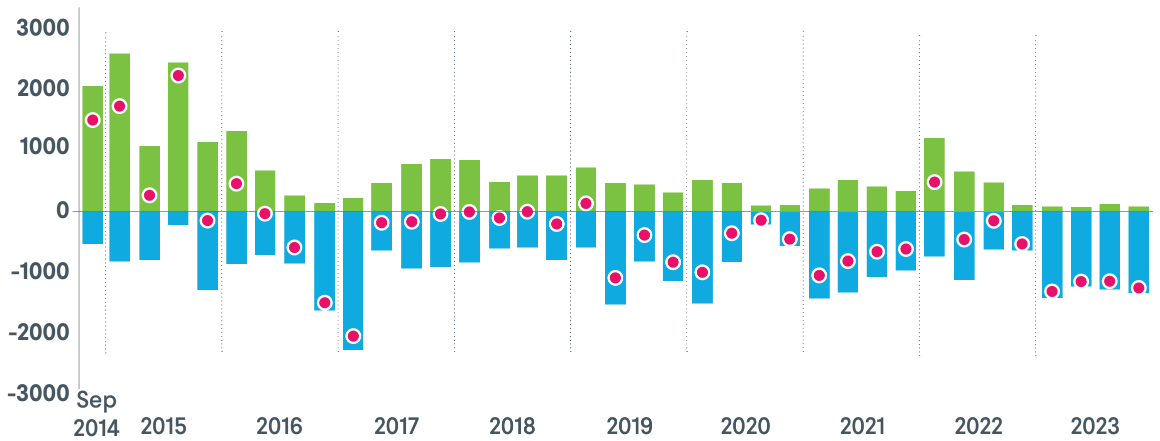
UK property

The UK property market deteriorated significantly over the second half of 2022 and continued to struggle through most of 2023. According to MSCI, capital values dropped over 24% from the peak of the market in the middle of 2022 to the end of December 2023.

The market has been awash with sellers as many private sector DB pension schemes have been looking to exit the market over the last 18 months. You can see this trend in chart one, below. This follows many schemes reaching funding-level triggers, which indicate that they no longer need the volatility and illiquidity risk of property. The volume of sales needed to provide redeeming investors with an exit could potentially create an opportunity for investors to enter the market at a more attractive price.

Price discovery has been difficult, as the transaction market has been very thin. This would indicate both that there aren't a lot of buyers in the market and that, for the most part, sellers aren't willing to sell at any cost.

Property funds' net investment in property (GBPm)



Source: MSCI and AREF

Obsolescence risk grows

Tenant and investor demand for more energy-efficient properties is increasing the obsolescence risk of some assets, placing additional pressure on valuations. There is an increasing divergence between assets that meet current and future environmental standards versus those that do not. Better-quality assets are more attractive to buyers and are experiencing greater liquidity and superior rental prospects. In the office sector, we expect further capital declines, but expect the highest-quality offices in strong locations to be better insulated.

The outlook for pooled funds

A consequence of all this selling activity is that the pooled fund universe is likely to be smaller in the future. There are likely to be fewer funds in the peer group, and those funds may well be smaller. That said, we do expect to see some consolidation, with potential takeovers or mergers of funds. For pooled funds to survive, they'll need a more diversified investor base. Managers are increasing their marketing efforts in an attempt to bring in foreign capital and looking at ways to attract DC investment. It's clear that both options will be challenging for many funds.

Is diversification on the cards?

Despite the headwinds in recent years, UK property has continued to provide a fairly steady income return, while its low correlation to other asset classes makes it effective at reducing the overall risk of portfolios. It can also be used as an asset to add value and can provide some inflation protection.

We expect more clients to diversify their property allocation to allow exposure to different types of strategies. We've already seen some clients make dedicated investments in the residential sector, both in private build-to-rent and in affordable housing strategies. There are other alternative opportunities that could potentially add more value and have a broader impact, for example a strategy to refurbish older buildings to become more energy efficient, effectively creating new core assets. Another option might be an allocation to real estate debt over the next part of the cycle.

Private debt

Are we in the 'golden age' of private credit?

Throughout 2023, we heard many managers and journalists refer to this as the 'golden age' of private credit. We've left behind the near-zero interest rate environment that followed the global financial crisis, and the higher base rates mean higher returns for direct lending, as it's a floating-rate asset class. This benefits investors, and it could well prove the theory. But we need to be cautious about the other edge of the higher-rates sword – higher base rates mean higher debt burdens for companies to meet. Alongside other increased costs, thanks to inflation, this will squeeze leverage multiples and makes higher levels of default very likely.

The other factor that should give caution is the sheer amount of capital that's flowed into the asset class. While fundraising was a struggle across private markets in general, investor allocations were most robust in private debt. The amount of 'dry powder' has increased, putting pressure on managers to deploy capital to start earning fees (typically charged on invested capital in direct lending).

Overall, however, we expect the higher interest rates environment to underpin higher returns for direct lending, and we expect vintages investing now to perform better than historical funds as managers can underwrite more cautiously.

Almost across the board in private markets, we're seeing high interest rates translate to attractive relative value for debt holders. Debt is currently expensive, and as the equity owner has to pay this expensive debt, it eats away at their returns while providing higher returns for debt holders. This relative value seems especially present in real asset debt, both real estate and infrastructure.

Areas of diversification

We expect investors to seek further diversification away from the corporate risk of direct lending, given the weakening fundamental outlook for corporates. We note that strategies such as asset-backed lending, regulatory capital relief and fund financing are potential areas of interest. Meanwhile, opportunistic credit investors may take advantage of the aforementioned stress in the system. Likewise, we think investors may consider real asset debt as a relative value alternative to their real asset equity allocations. We note that the credit secondaries market is continuing to mature and offers attractive returns, given a stark difference in supply and demand.

Natural capital

Natural capital describes physical assets: renewable assets, such as trees, and non-renewables, such as fossil fuels and minerals. It also includes ecosystems like oceans, forests, wetlands and grasslands. Natural capital provides us with the resources we need to survive and thrive, but the Earth's natural resources and environment are under pressure.

There's an increasing global focus on the importance of natural capital. This is creating opportunities to invest in assets that can contribute to the preservation, protection and regeneration of natural capital, some of which haven't been available to institutional investors before.

A broad range of investment funds are being marketed as a 'natural capital' investment – from listed equity and debt strategies, through to illiquid assets. We've grouped the opportunities into three categories:

- Investing directly in natural capital assets – for example, timberland or farmland
- Investing into or monetising financial credits based on regulating services, such as carbon credits or biodiversity net gain credits
- Investing in technology that supports natural capital – or into businesses looking to support ecosystem services. For example, providing debt or equity to a company focused on developing a new fertiliser or delivering a clean water project.

Some underlying strategies are well established, with long track records, while others are newly emerging, without a track record. It will take time for the latter to reach sufficient scale for meaningful institutional investment.

Many natural capital investments aim to create measurable, positive environmental outcomes. And it's possible to target specific areas of focus, such as climate mitigation or biodiversity. The ability to drive a positive climate impact is a key factor influencing the growth in interest – particularly as investors start to plan their net zero journey paths. The majority of the more interesting or impactful opportunities that we're focusing on have been within private markets.

But it's not all about impact. There are other reasons to consider an investment – perhaps most importantly, longer-term returns that are often not directly linked to the economic cycle. This leads to a low correlation with other asset classes and presents natural capital as a good asset class for portfolio diversification.

Natural capital assets can also provide some inflation protection, which makes sense as many products made from natural resources are key inputs into inflation calculations. And several other considerations positively influence the fundamental return drivers, such as urbanisation, an increased demand for sustainably managed natural capital assets and products, and the long-term transition to a low-carbon economy.

Conclusion

We've touched on a few of the current focuses for our clients, but we've barely scratched the surface. There's a broad range of investment styles, risk appetites, geographies and sectors to choose from when investing in private markets, and our clients are reviewing options across all of these. However, allocations are very dependent on each client's risk appetite. The illiquidity of private markets means allocations are not appropriate for investors who are unwilling to lock capital away for several years.

Even with evergreen vehicles becoming more prevalent, investors should still treat allocations to private markets as part of a longer-term strategy (the shortest closed-ended funds are typically seven years long, once extensions are considered). Some previous private market investors will no longer be able to take the illiquidity risk. But who will replace them?

For many years, private market fund managers and DC consultants have been exploring options to include private markets within DC investment portfolios. Will the newly launched Long Term Asset Funds (LTAF) prove to be the vehicle that unlocks the floodgates for UK DC money? It's possible. It's also likely that fees will come under pressure for managers who want to enter this space – the typical private market fee construction of a base fee plus performance fee may need to be reconsidered for new investors wishing to enter the market.

To discuss private market investing in more depth, please speak to your usual Hymans Robertson consultant.

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RI in 2024: Focusing on what matters

Responsible investment (RI) has become an increasingly challenging area, with asset owners required to navigate activism groups, regulatory change, increased reporting requirements and growing public scrutiny. All this while ensuring environmental, social and governance (ESG) risks are being successfully managed. Cutting through the noise, we took a step back and posed ourselves this question: what do asset owners really want to achieve from their RI strategy?

The answer is the three focus pillars that form the core of our updated RI mission statement:

- Achieving net zero
- Being better stewards
- Creating positive impact

In this article, we explore each of these pillars and what they mean for our research and advice over the course of 2024 and beyond.

Achieving net zero

We know the world must go through a period of systemic change if we're to protect our environment, societies and economy from climate change and biodiversity loss. The collective goal is that of a low-carbon economy and the pursuit of 'net zero'.

Setting a net zero ambition is something we believe should be considered by all, regardless of their investment time horizon. For example, those considering risk transfer can reflect their goals within insurer selection, thereby reflecting a focus on long-term financial security. This aligns with the purpose in setting an ambition and creates a focus on the actions that can be taken to help achieve the longer-term goal.

A priority for asset owners over 2024 should be creating, and then implementing, Climate Transition Action Plans. This act places a focus on four key areas: portfolio emissions, transition alignment, climate solutions and opportunities, and engaging for change – all of which are levers that can be pulled by asset owners to try to effect real world change.

We continue to see opportunities for investment in changing energy systems, but there's also the potential for aligning capital with organisations that are both core to the transition, and for whom the transition will be long and complex. Forming a detailed understanding of investment portfolios, the actions being taken by individual companies and ensuring that positive activity is being supported will be vital.

Equally, we recognise the importance of biodiversity and protecting our natural capital, this being inextricably linked to climate change. The work of the TNFD has brought nature to the fore, but we want to ensure this is not a reporting exercise, but a means for driving action.

Finding a place to start can be hard, but it's critical. We'll be focusing on two key areas over 2024: deforestation and marine biodiversity. That means helping asset owners understand how they can look at their portfolios to understand risk exposures, and to create dialogue with asset managers on these topics.

Being better stewards

Asset owners have a role to play in overseeing the assets managed on their behalf. They should thoughtfully – and, where necessary, forcefully – exercise stewardship within their sphere of influence.

We recognise that effective stewardship can be time consuming, and we'll continue to make it more accessible. We've already helped several clients build engagement frameworks to shape discussions with asset managers and build accountability; we want to help others do the same.

Planning is an essential part of this process, including the setting of stewardship priorities. It's important to identify managers you're planning to engage with, the priority topics for discussion, and the outcomes that you're trying to achieve.

We'll focus on social factors over the course of 2024, recognising that there is a clear overlap between social and environmental issues, particularly to support a just transition. Two major topics will be:

Modern slavery: Affecting an estimated 50 million people worldwide, modern slavery is pervasive in the private sector, affecting people in construction, agriculture and domestic work. Regulatory change is increasing the focus on modern slavery, and organisations are being challenged to respond through implementing appropriate policies and improving disclosure and accountability when subcontractors are used.

Artificial intelligence: AI threatens to be a disruptive force, creating potential value for investors but with potential ill effects for people and human capital. AI offers improved productivity and management, but risks include the creation and propagation of misinformation, discrimination through biased algorithms, and a lack of transparency in decision-making. Our recent survey of asset managers suggested that AI risks should be considered more carefully, and we need to better understand the safeguards being put in place.

Finally, we recognise that stewardship is more powerful when you can amplify your voice. When an asset owner engages with an asset manager, their impact is multiplied when their agenda is echoed by others. Our in-development Asset Manager Engagement Service will provide a mechanism for asset owners to achieve this.

Creating positive impact

Assets are invested to generate economic return, but many assets also directly or indirectly affect society and the environment. Being clear on the desired outcomes is essential to create impact, albeit asset owners must first define the sort of impact that they want to have, ie the themes they plan to focus on.

Theme selection is core to our approach to impact investment, and arguably the most important decision an impact investor might make. Our support to asset owners will increasingly bring in relevant evidence and research to support this difficult decision. Here are examples of how themes and asset allocation may overlap:

Investments in timberland can achieve positive **climate** impact and perhaps **biodiversity** benefits.

Investments in real estate can achieve positive **climate** impact by making a building more energy efficient and climate-friendly sooner. This can also improve indoor air quality, improving the **health** of occupants.

Some private equity funds can provide early-stage drug companies with capital and expertise, helping them get drugs to market sooner and more safely, bringing about a positive **health** impact.

Assessing how impactful investment opportunities are is a complex topic. Our IxA framework seeks to quantify the amount of impact any given investment may have. It's an approach we'll use to both assess options and help our clients implement their impact strategy. This framework also helps asset owners to have more impact, and ensures that their impact investing is legitimate, creating genuine impact.

Looking forward

The three pillars of our RI activities reflect the broad goals of asset owners and lie at the core of our research over 2024 and beyond. However, within each pillar lies a series of challenges and the need to establish what matters most while continuing to meet fiduciary obligations. For some, this will still involve finding the most appropriate starting point for their particular circumstances. We'll be launching our RI Health Check to help asset owners at all stages of their journey determine what they want to do next.

To find out more about how Hymans Robertson can help you respond to RI risks and opportunities, please speak to your usual consultant.

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Capital Markets Update

Welcome to our quarterly Capital Markets Update, in which I explore key themes driving the global economy and examine the prospects for individual asset classes.

Q4 summary

- Global growth defied all but the most optimistic forecasts in 2023, despite the steep rate-hiking cycle of the past two years
- Business and consumer confidence is rising, as inflation fears recede and the prospect of interest-rate cuts comes in to view
- Bond yields fell sharply in quarter four due to expectations of earlier and larger rate cuts in 2024 than previously thought
- Falling yields alleviated concerns over debt affordability, and lent valuation support to stocks
- Credit spreads fell and equities rallied strongly

Key themes

At 2.6%, global growth exceeds expectations

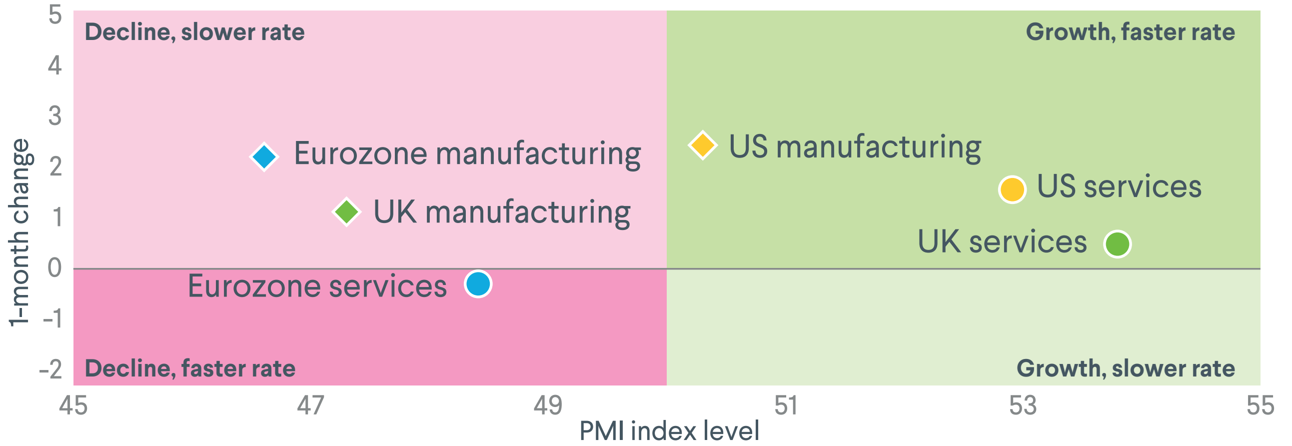
Global growth confounded expectations in 2023. Full-year real global GDP growth was around 2.6% in 2023, despite forecasts of a slowdown to 1.5% as higher interest rates, energy prices and a cost-of-living squeeze weighed on consumers and business. This is a large margin of error, even by the standards of economic forecasts.

Consumers spend pandemic savings

Forecasters underestimated the resilience of consumer spending and the extent to which consumers would use savings built up during the pandemic, particularly in the US. The US economy was expected to stagnate in 2023; instead, real GDP looks to have risen 2.5%, making the US economy the engine of growth among the major advanced economies.

Economists also underestimated the lag with which monetary policy would affect activity – more fixed-rate mortgages, fewer mortgage holders and larger debts concentrated among wealthier, savings-rich households, have been cited. To the extent that the full impact of interest-rate rises is yet to be felt, a degree of caution is still warranted. However, falling inflation and the prospect of interest-rate cuts in 2024 eases debt affordability concerns for consumers and corporates, and improves the balance of risks to the outlook.

Chart 1: Recent business surveys suggest activity is continuing to defy downbeat expectations

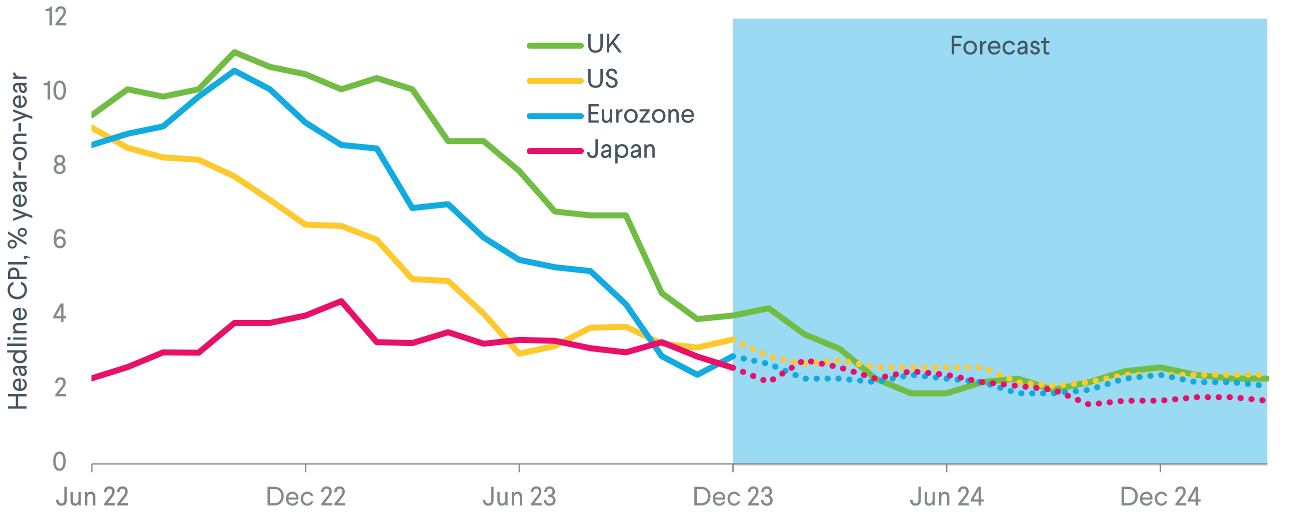


Source: Bloomberg

As you can see in **Chart 1**, recent PMI data point to a healthy US economy, positive momentum in the UK, and an easing (at least) of the downturn in the eurozone. Though, in aggregate, activity in the energy price and interest-rate sensitive manufacturing sector remains much weaker than in the more labour-intensive service sector.

And therein lies another key risk to the outlook. Further declines in headline inflation (**Chart 2**) should enable the major central banks to start reducing interest rates in the second half of 2024. But tight labour markets and strong wage and services inflation mean the pace of decline is likely to slow. Easy wins from falling energy and moderating food and goods prices are largely in the rear-view mirror. And here, too, there are risks, with developments in the Red Sea posing a threat to global supply chains and oil prices. However, for now, pandemic-era inflation feels unlikely, given weak manufacturing activity and a more manageable rise in freight costs.

Chart 2: Further declines in inflation, if realised, should allow central banks some breathing room in 2024



Source: Datastream

As effective interest rates continue to rise, real global GDP growth is expected to slow to a relatively subdued pace of 2.2% in 2024, before re-accelerating to 2.5% in 2025. However, better-than-expected economic data and falling inflation, bringing the prospect of interest rate cuts into view, mean the risks around the outlook are more evenly balanced. Negative inflation developments, which could rule out lower interest rates, leading to tightening of financial conditions via the financial markets, are a key downside risk.

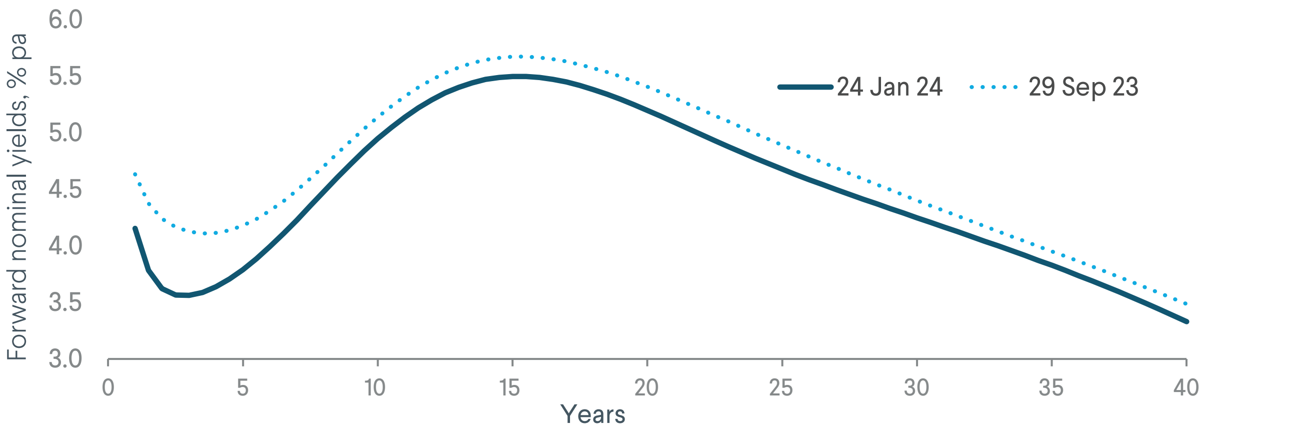
Asset-class views

Government bonds

Declining inflation, alongside lacklustre real growth forecasts for the UK economy, improves the fundamental outlook for gilts. Despite the recent rally, forward nominal yields still look elevated (**Chart 3**) versus our assessment of fair value, based on long-term real growth and inflation forecasts. It's true that there may be some indigestion if the extent of interest-rate cuts priced in to the front end of the curve fail to materialise in the near term, particularly at a time of heavy government issuance and Bank of England asset sales. However, falling inflation and the potential interest-rate cuts that follow may place further downwards pressure on yields.

While subsiding fears about long-term inflation to a certain extent reduce the fundamental support for index-linked gilts, real yields remain at reasonable levels at a time when real growth is expected to be barely positive in the near term. Gilt-implied inflation still looks slightly high relative to central bank targets, particularly after we allow retail price index and consumer price index (RPI/CPI) reform. However, investors with lingering concerns about longer-term risks to inflation may be willing to pay a higher-than-usual inflation risk premium.

Chart 3: Forward nominal yields imply cash rates well in excess of what we would consider neutral



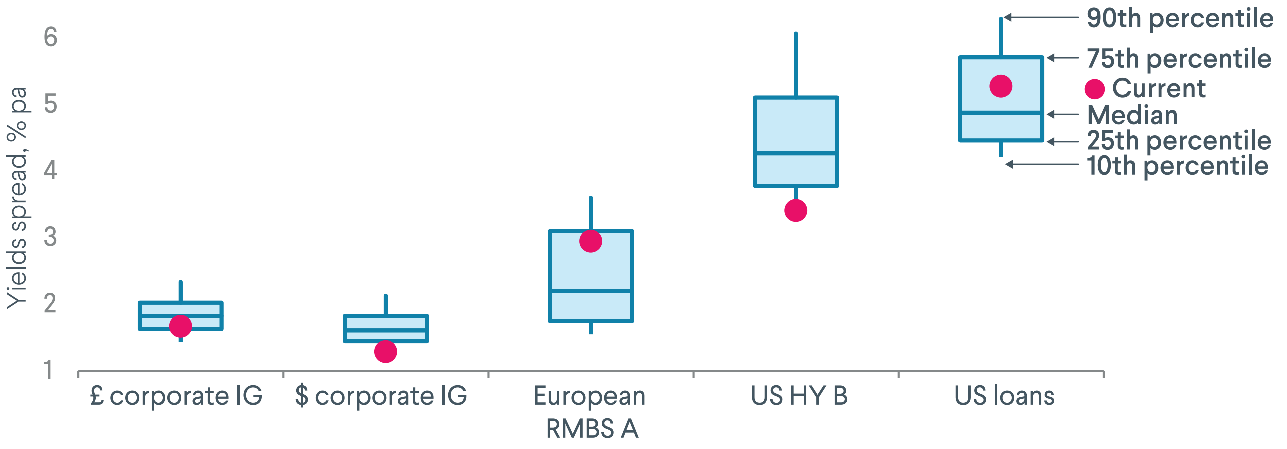
Source: Bank of England

Credit

The prospect of interest-rate cuts and the recent easing in financial conditions, via lower sovereign bond yields, is a welcome development for credit fundamentals. Debt affordability metrics could deteriorate as effective interest rates continue to rise for some time. On average, current yields are above existing coupon rates, meaning maturing debt will be refinanced at higher rates. But the increase in debt costs will be gradual and looks manageable, given limited near-term refinancing pressure and the prospect of interest-rate cuts and improved corporate earnings in 2024 and 2025. Indeed, Moody's expects the default rate to peak at 4.9% in Q1 2024, slightly above current levels and not far above long-term averages.

However, markets have already priced in this benign outlook, and credit spreads have fallen sharply. Some of this may be justified, as default rates are close to peaking and attractive yields provide a cushion against potential spread widening and/or a back-up in underlying rates. But positive sentiment has driven corporate credit spreads well below long-term averages, particularly in fixed-interest markets, where investors have sought to lock in higher yields for longer. Credit spreads at these levels leave little scope for disappointment, and there may be better entry points ahead. We see better value in floating-rate asset-backed securities and loans in investment- and speculative-grade markets, respectively.

Chart 4: Credit spreads leave little scope for disappointment, particularly in fixed-interest markets



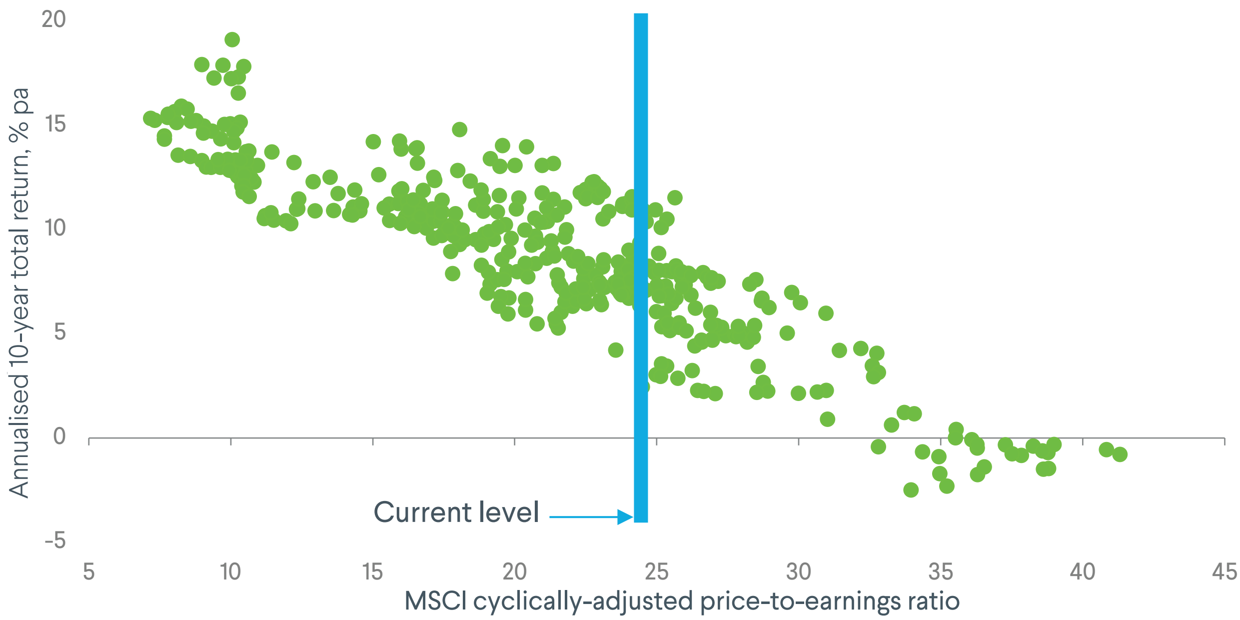
Source: ICE Index Platform, Barings

Equities

Following flat, full-year earnings growth in 2023, analysts' earnings forecasts for global equities for 2024 and 2025 are healthier, at 10% and 12%, respectively. However, there are risks to the earnings outlook as growth and demand slows. The expectation that global profit margins rebound towards their post-pandemic high may be challenged by higher effective interest rates and employment costs, and waning corporate pricing power. Market performance in the final couple of months of 2023 drove cyclically adjusted valuations above long-term averages – something that has historically augured periods of more subdued subsequent returns (**Chart 5**).

The underperformance of emerging markets over the past few years leaves valuations looking cheap relative to developed markets, even allowing for the usual level of discount observed historically. Emerging markets are forecast to experience the strongest earnings growth among the major equity regions in 2024 and 2025. Despite outperformance in 2023, Japanese equities still look relatively cheap, while relative earnings growth forecasts, and ongoing upgrades to those forecasts, remain supportive. US valuations are high, but look slightly less stretched in the context of usual premium commanded by the tech-heavy market and derive support from relatively strong potential earnings. We're most cautious on European and UK equities, where a relatively poor earnings outlook may more than offset the ostensible cheapness of these markets.

Chart 5: There is strong correlation between equity valuations and subsequent medium-term returns



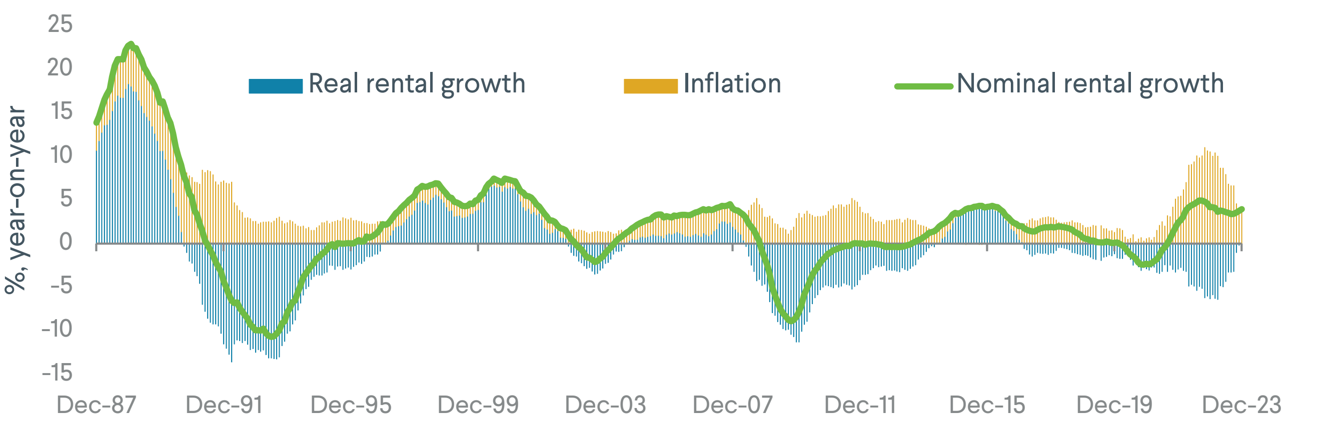
Source: Datastream

Property

As inflation has fallen sharply, real rental growth has risen (Chart 6), slightly improving the fundamental outlook for UK commercial property. However, a further 2.6% decline in the MSCI UK Monthly Property Capital Value Index in the three months to end-December highlights the structural challenges facing the office and retail sectors. The Royal Institute of Chartered Surveyors' latest survey points to ongoing falls in occupier demand and rent expectations, and rising availability and inducements offered to tenants in both of these sectors. On a longer-term view, we expect tenant demand for quality, and more energy and environmentally efficient buildings, to attract tenants and command higher rents. We feel that tenants and owners will increasingly focus on achieving higher EPC and green standards which may cause a divergence in the market in the future.

Given the 24.4% fall in MSCI UK Monthly Property Capital Value Index since its June 2022 peak, and decent nominal rental growth over the same period, net initial yields, based on current rental income, have risen to 5.5% pa. Gross reversionary yields, based on estimated rental value, have risen much more, to 7.2% pa, perhaps highlighting the increasing asset-management opportunities available in the market. Meanwhile, the technical picture remains challenging, and many UK pooled property funds continue to defer redemptions, with 'gating' in place since the second half of 2022.

Chart 6: Real rental growth is rising, given decent nominal rental growth and declining inflation



Source: MSCI UK IPD Monthly

Conclusion

While global growth is forecast to slow to a relatively subdued pace in 2024, recent resilient economic activity, declining inflation, and easing financial conditions point to a more benign outlook. Moreover, corporate fundamentals look well placed to absorb the ongoing rise in effective interest rates, while consumers will welcome easing inflationary pressures and falls in short-term market interest rates.

However, risk assets have more than moved to price in an easing of downside risks. Credit spreads leave little scope for disappointment, and global equity valuations are now substantially above long-term averages. The fundamental outlook for property markets might have slightly improved and valuations no longer look demanding, but structural issues remain, and the technical picture is still challenging.

There may be better entry points to risk markets ahead, and, in addition to employing usual rebalancing discipline, we would be more comfortable with slightly higher allocations to government bonds and cash than strategic considerations might require. The former still offer decent forward nominal yields and should provide substantial ballast in a more severe downside growth and inflation outcome. The latter now provides a real return to sit on the sidelines and would be the funding asset of choice should inflation disappointment and re-evaluation of interest-rate expectations cause correlated repricing of bond, credit, and equity markets.

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