Alternative Income Study

2018

Contents

Foreword

Whatever the name, the story's the same

Alternative income, real assets, private assets, illiquids: however they are described, the appeal of unlisted assets has grown significantly among European pension funds and insurers over the past decade.

It is not difficult to understand why this trend has emerged. In an investment world fuelled by quantitative easing (QE), interest rates were pushed down to historic lows. Institutional investors have been lured by higher expected returns from private assets over publicly-traded ones of broadly similar credit quality; a yield uplift known as the illiquidity premium, as well as other benefits such as diversification and downside protection.

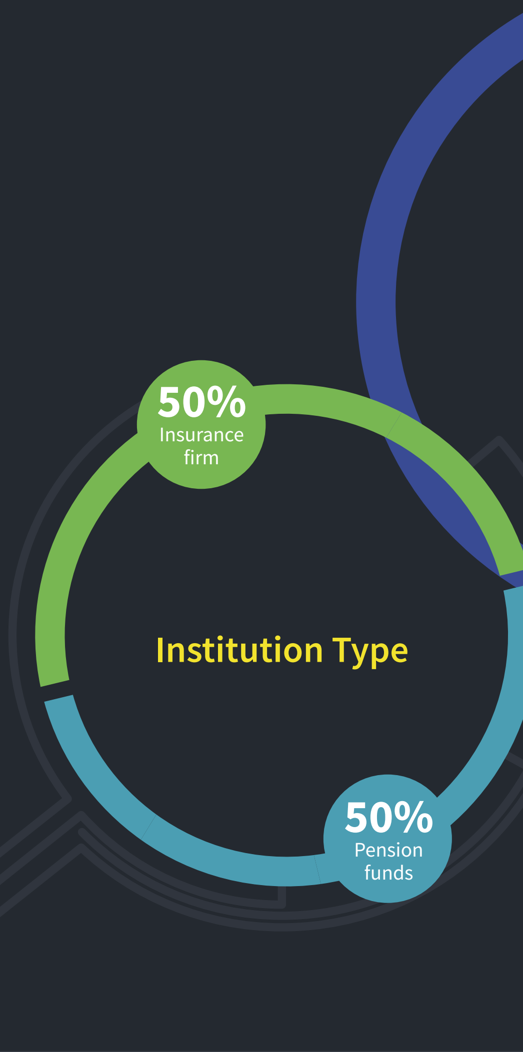
All of these factors have enhanced the case for increasing allocations to private assets. But as the era of QE finally winds down and interest rates rise, new questions arise: can sufficient margins still be found in private markets; will the credit risk that has been dormant for so long become something to fear again?

The changing investment environment will certainly have an influence on allocations, while both pension funds and insurers also face complex organisational and regulatory challenges. Insurers, for example, need to consider the evolving risk-based capital requirements of the European Union's Solvency II Directive.

Our new research reveals how European insurers and pension funds are embracing alternative income assets in their portfolios. It finds that target allocations are still going up, and that the search for assets is pushing investors into new sectors and geographies. In addition, it draws on insights from experienced investors along with our own team to address some of the challenges of building an alternative income portfolio. For the purposes of this study, alternative income assets includes: infrastructure debt, structured finance, infrastructure equity, real estate finance, private corporate debt and real estate long income.

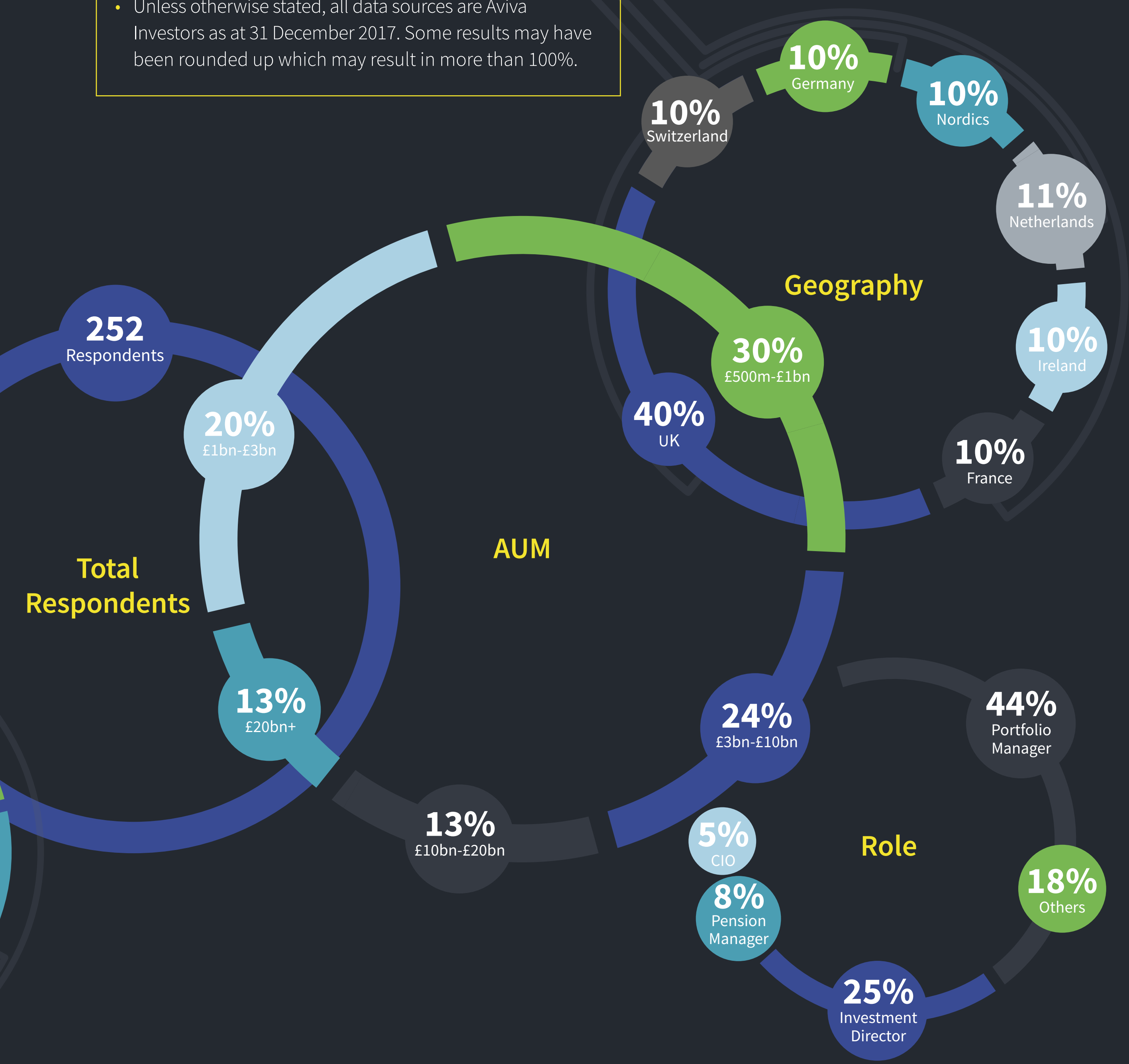
One thing is clear: investors need a carefully considered and highly selective approach to achieve the best outcomes from their private asset investments.

Euan Munro
Chief Executive Officer,
Aviva Investors



About the Research

- Aviva Investors commissioned Longitude Research to conduct a study of more than 250 investment decision-makers at insurance and pension funds across Europe.
- A programme of in-depth qualitative interviews with senior investment professionals at insurers and pension funds was also conducted.
- The research was completed at the end of Q4 2017.
- Unless otherwise stated, all data sources are Aviva Investors as at 31 December 2017. Some results may have been rounded up which may result in more than 100%.



Key findings

Factors driving increasing allocations

Overview

Since the global financial crisis, many large institutional investors have been paying greater attention to alternative income assets. With the era of ultra low interest rates helping to stretch valuations in bond and equity markets, institutional investors are looking elsewhere for attractive risk-adjusted returns. Factor in uncertainties surrounding geopolitics and international trade, and the case for diversifying portfolios using alternative income assets looks stronger than ever.

Our research shows many insurers and pension funds across the UK and Continental Europe are seeking to boost their allocations to infrastructure, real estate debt and private corporate debt, among other assets.

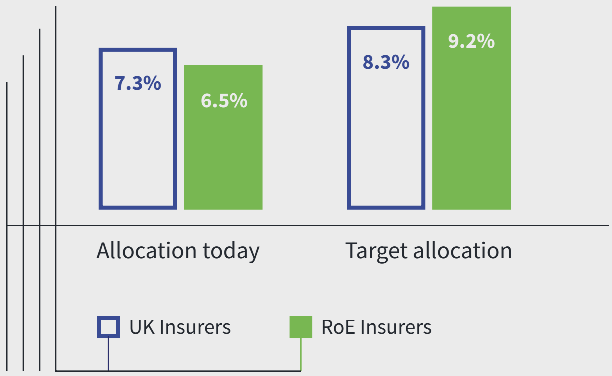
Overall, insurers in Continental Europe (Denmark, France, Germany, Ireland, Netherlands, Norway, Sweden and Switzerland) are planning to increase their holdings of alternative income assets from 6.5 per cent to 9.2 per cent of their portfolios. UK insurers are targeting a more modest 8.3 per cent allocation, up from a current average of 7.3 per cent.

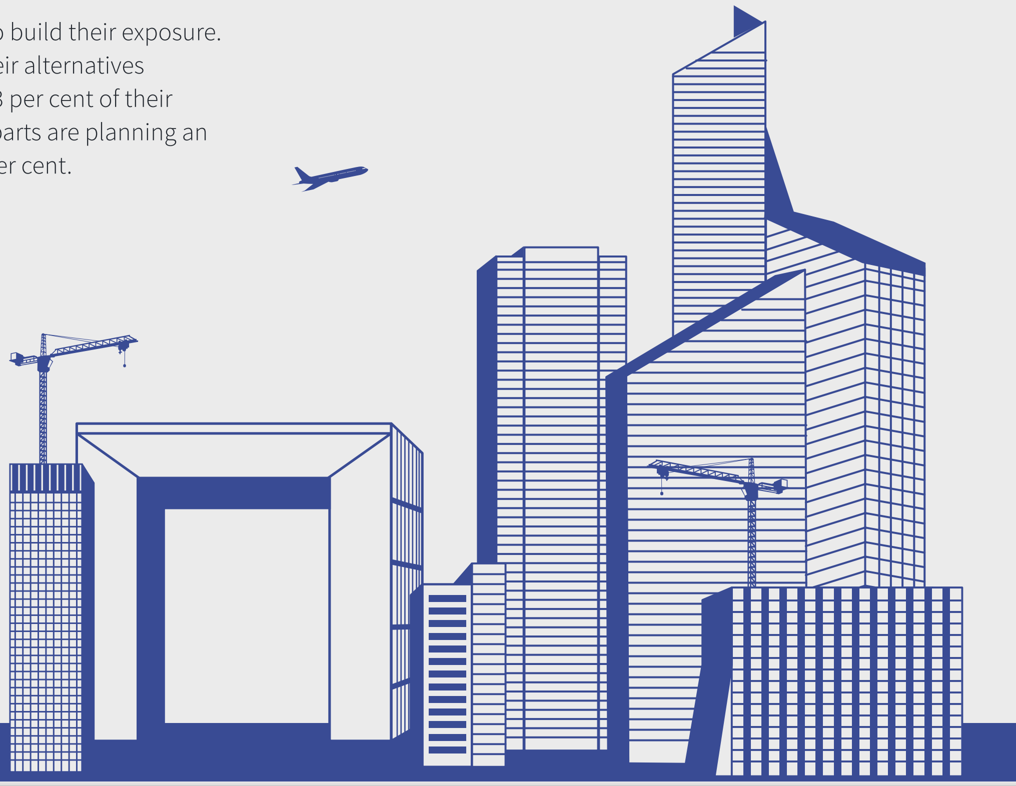
Pension funds are also planning to build their exposure. European funds intend to raise their alternatives allocations from 5.2 per cent to 7.3 per cent of their portfolios, while their UK counterparts are planning an increase from 4.3 per cent to 6.5 per cent.

European insurers set to lead the way in alternative income allocations

How is your institution's investment portfolio allocated today? What is your institution's target allocation to alternative income assets?

FIGURE 1

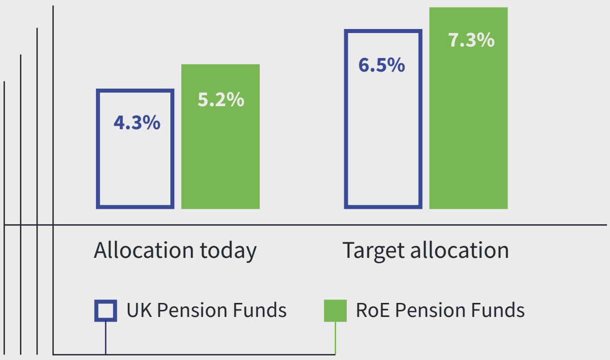




European pensions target deeper alternative income allocation

How is your institution's investment portfolio allocated today? What is your institution's target allocation to alternative income assets?

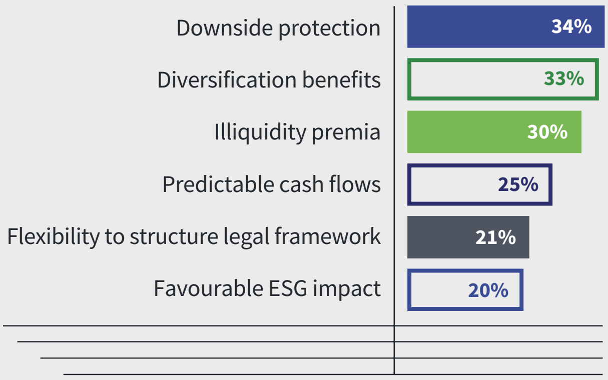
FIGURE 2



Factors driving allocation to alternative income (percentage citing 6/7 out of 7 on importance scale)

How important were each of the following potential outcomes in your institution's decision to increase its portfolio allocation to alternative income assets?

FIGURE 3



Key drivers of shifting allocations

The reasons behind increased appetite for alternative income differ depending on the institution and its specific requirements, but some broad themes are evident. Our study finds both insurers and pension funds are chiefly interested in the downside protection alternatives can offer in the event of a correction in listed markets, as well as the diversification benefits and illiquidity premia they may provide.

As Markus Pauli, CIO, Alternative Investments at Finland's KEVA stated: "Our main driver is the market and low yield environment: we need yields from somewhere so that has been one of the bigger drivers. It has been quite an easy decision to put more assets into this than typical liquid assets. We try to diversify risk with lower correlation to other asset classes, but we also are searching for higher returns and that is one of the reasons we are focusing on alternatives."

For insurers, regulation may also account for some of the increased demand. Under the Solvency II regime, some alternative income assets now benefit from reduced capital charges under the Standard Formula, including qualifying infrastructure debt and infrastructure equity. And certain real estate finance transactions can also benefit from reduced capital charges, reflecting the security provided by the underlying collateral.

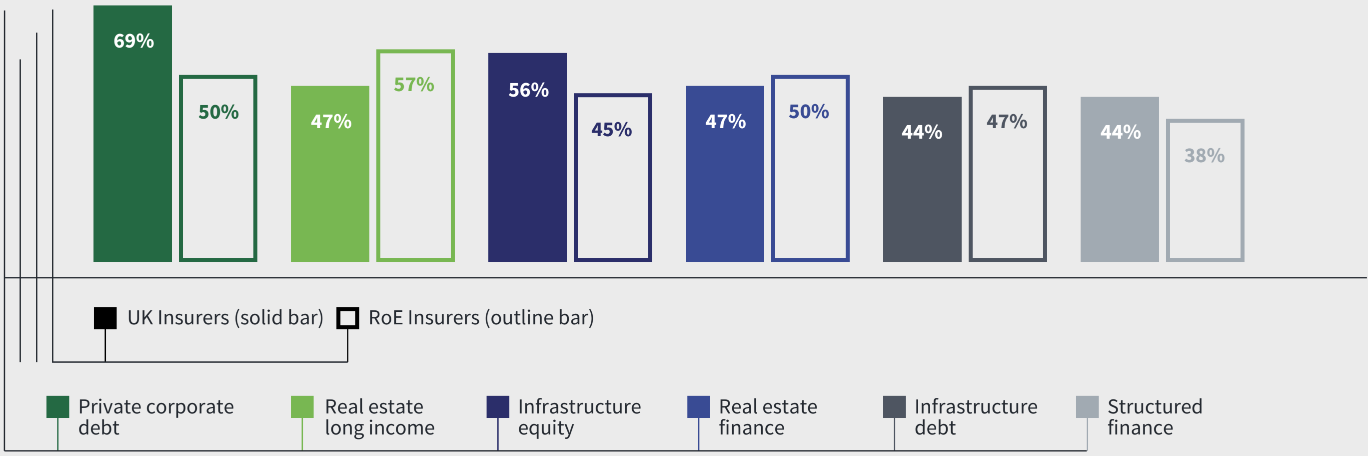
There are, however, a number of factors that may affect the ease with which insurers are able to integrate alternative assets. In particular, there are strong regional variations across the UK and Continental Europe (see Section 3).

Asset classes

Insurers' current allocation to alternative income sub-categories — UK vs. Rest of Europe

Does your institution have any allocations to the following sub-categories of alternative income assets today?

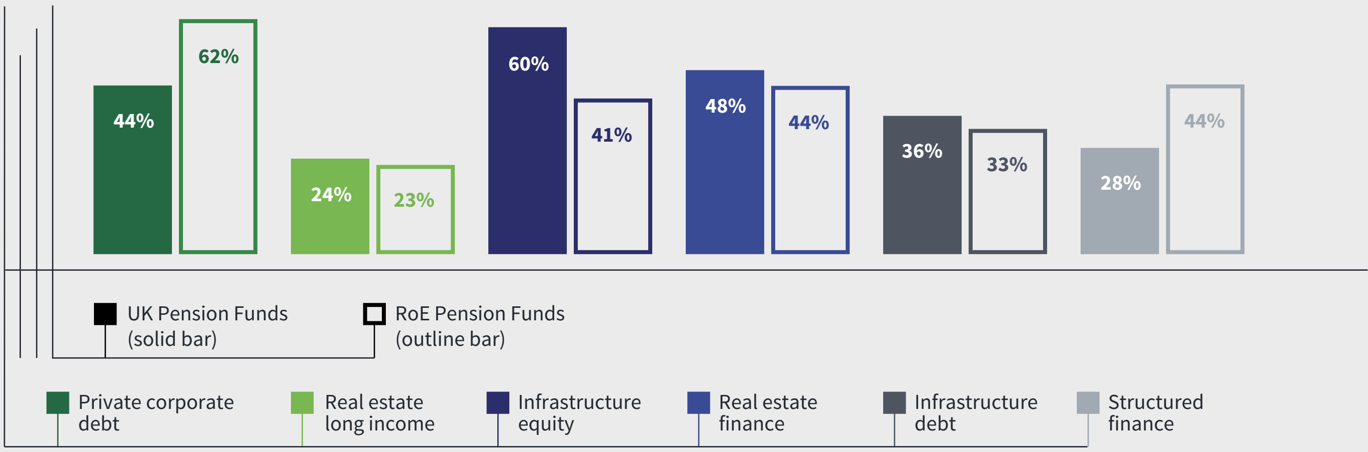
FIGURE 4

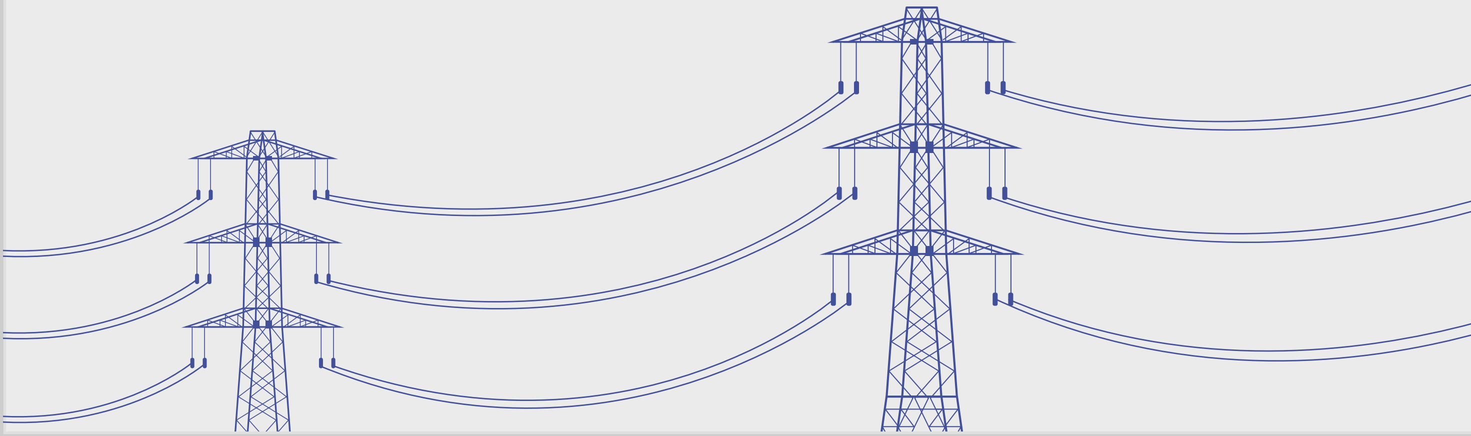


Pension Funds' current allocation to alternative income sub-categories — UK vs. Rest of Europe

Does your institution have any allocations to the following sub-categories of alternative income assets today?

FIGURE 5





Private corporate debt is the most commonly-held alternative income asset among the insurers we surveyed. Of insurers that already have some exposure to alternative assets, 57 per cent hold private corporate debt and 53 per cent hold real estate long income investments. Percentage figures are the aggregate of the UK and Continental Europe.

Mikko Mursula, Chief Investment Officer of Finland's Ilmarinen Mutual Pension Insurance Company, summed things up succinctly: "Private corporate debt is one of the places where it is possible to find illiquidity premium."

Private corporate debt is also the most popular alternative income sub-category among pension funds: an average of 55 per cent of funds with an allocation to alternative income have some exposure to the asset class. We also found UK pension funds that have already invested in alternative income tend to hold more infrastructure equity than their European counterparts.

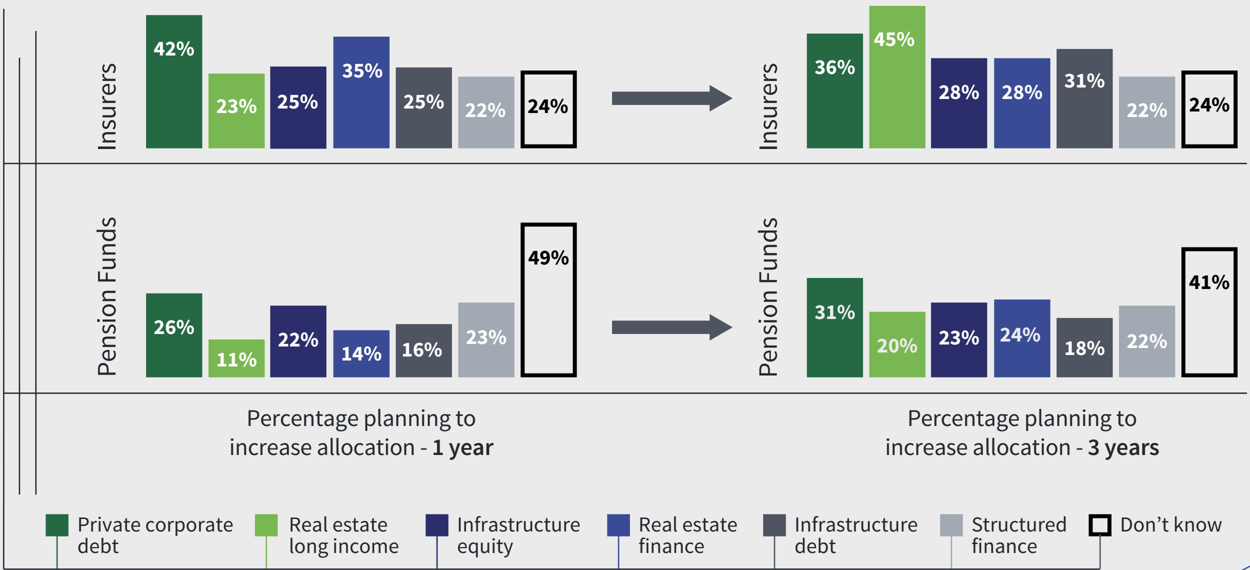
Our research shows insurers and pension funds are both aiming to raise their holdings of private corporate debt, with 42 per cent of insurers and 26 per cent of pension funds planning to increase their allocations within the next 12 months. The appeal of private corporate debt for these institutions lies in the better liquidity it offers compared with other alternative income assets, while still providing lower correlation to public market securities.

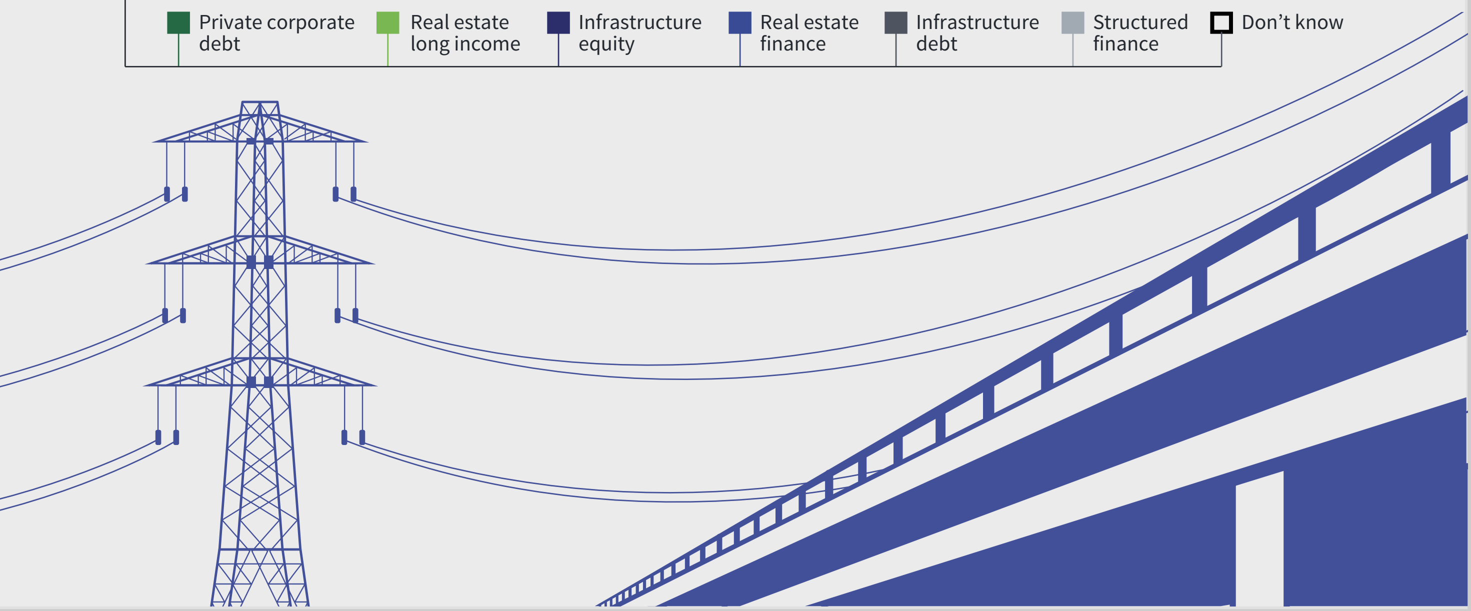
31 per cent of insurers are also planning to increase their holdings of infrastructure debt within the next three years, perhaps encouraged by the reduced capital charges under Solvency II.

Future allocation to alternative income categories — UK vs. Rest of Europe

Is your institution planning to increase its exposure to any of the following alternative income asset classes over the next one or three years?

FIGURE 6

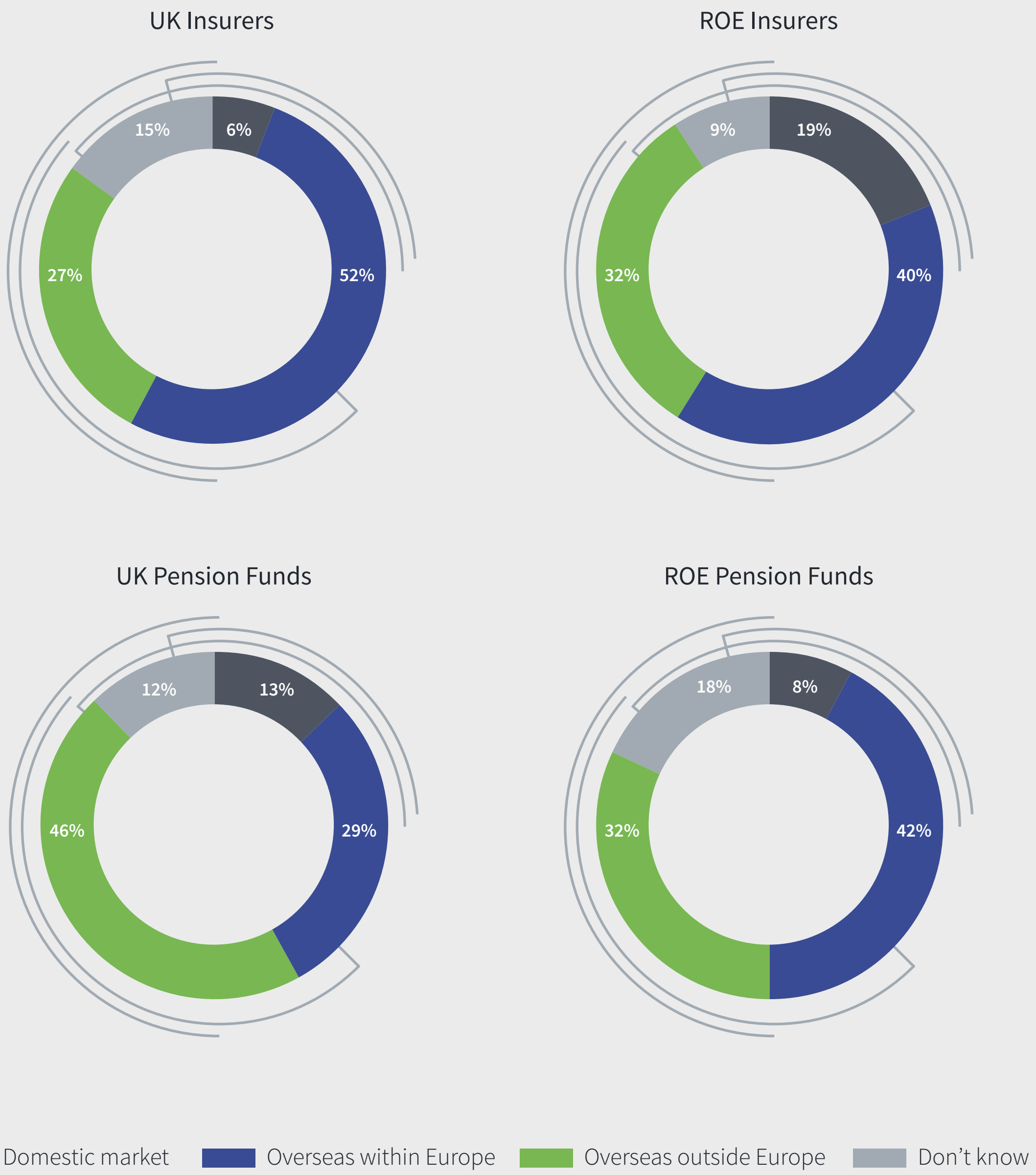


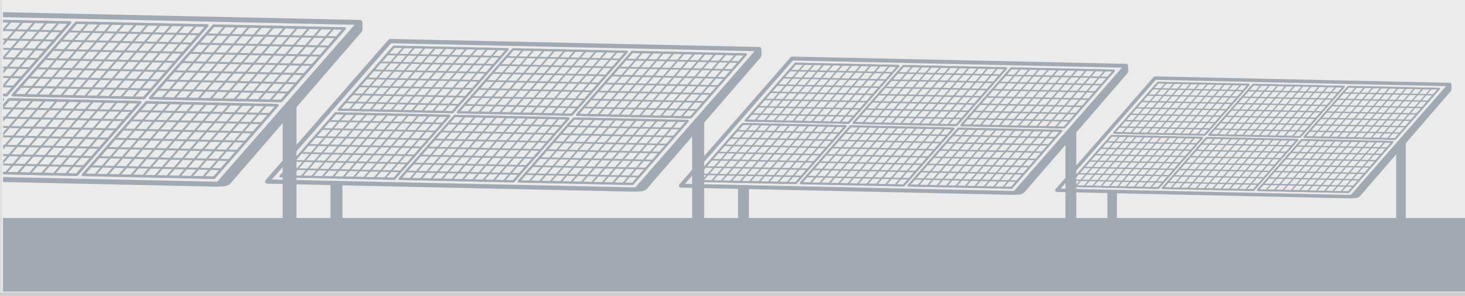


Home or abroad for alternative income opportunities?

Where do you expect to find the best alternative income investment opportunities over the next three years?

FIGURE 7





The majority of the investors we surveyed expect to find the best alternative investment opportunities beyond their domestic markets. Our findings show pension funds are more likely than insurers to venture outside of Europe to make such investments. For example, the Établissement de Retraite Additionnelle de la Fonction Publique (ERAFP), which manages a French public pension scheme, is planning to invest in US real estate for the first time in 2018 as it seeks to diversify its Europe-focused portfolio.

Increasing domestic competition for alternative assets is one reason why insurers and pension funds are looking further afield for opportunities: 46 per cent of our respondents said they expect higher competition will make it harder for them to find suitable investments in the future. This problem is likely to become more acute as more institutional money flows into alternative income.

Investment challenges

The extent to which institutional investors are able to build their exposure to alternative income assets may depend on the quality of their in-house expertise. Our findings indicate institutions are more wary about investing in asset classes in areas where they lack internal knowhow.

The majority of the investors we surveyed expect to find the best new alternative opportunities within Europe, but outside of their own domestic markets (see Figure 7).

The insurers we surveyed have the strongest in-house investment expertise in real estate finance and real estate long income, and to a lesser extent in private corporate debt. Expertise in infrastructure debt, by contrast, is relatively weak.

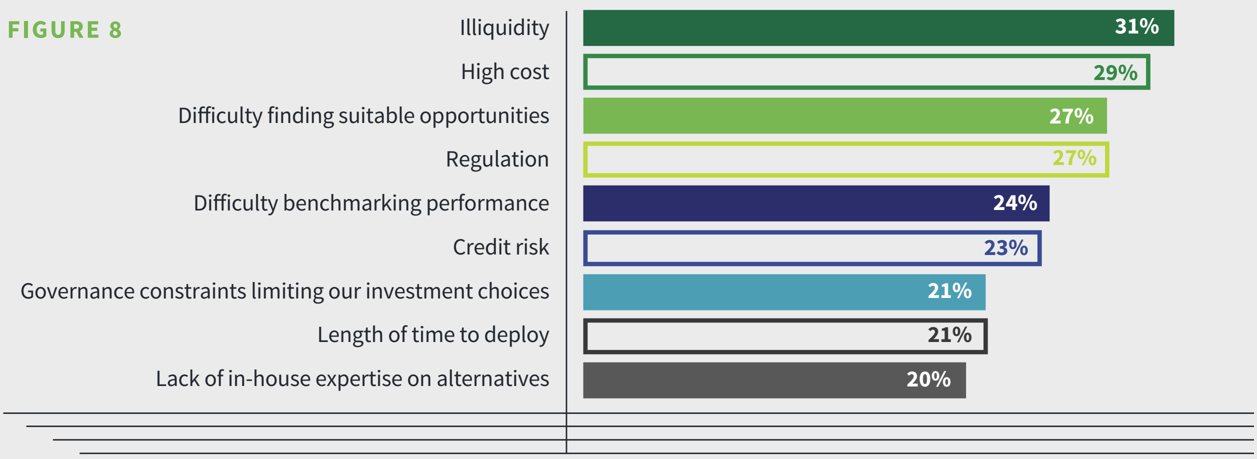
They also cited the high cost of implementing alternative strategies and difficulties identifying opportunities – along with regulation – as the biggest challenges they face when trying to build their exposure.

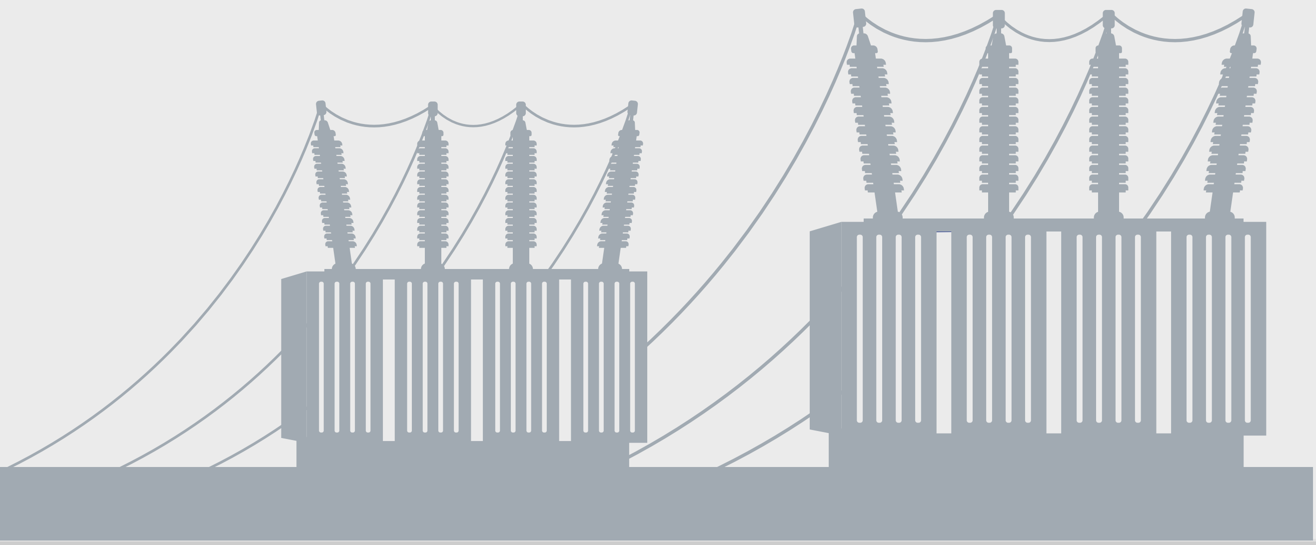
Both UK and Continental European pension funds cited the illiquidity of alternative income assets as the biggest barrier to increasing their allocations, followed by the high cost of implementation (for Continental European funds), and difficulty finding suitable opportunities was the second most commonly-cited barrier for UK pension funds.

Biggest challenges to increasing asset allocation

What would you identify as the biggest challenges to your institutiion increasing its allocation to alternative income assets?

FIGURE 8





Barry Fowler | Alternative Income Solutions | Aviva Investors

A Spotlight on:

European Private Debt

Q. Where do you see the most interesting private debt opportunities for institutional investors today?

A. We find that many investors are looking for assets that can be part of their cashflow strategies, designed relative to specific liabilities. They want three main things:

- Enhanced yield through an illiquidity premium.
- Diversifying credit exposure – Not necessarily just low risk, but they need to be able to understand, and be comfortable with the level of risk in the underlying assets.
- Security – senior, or even 'super senior' security is important, with cashflows secured against the underlying assets – and maybe even prepayment protection.

As a major provider of debt we are usually the lead lender and often the sole lender, which opens the door to deals where we will drive the structuring and deal terms, not just taking secondary loans that come to market. We have underwritten a number of large and varied infrastructure debt deals including rolling stock and road tunnels. We've also written a wide variety of non-standard transactions in the area we call 'structured finance', which can cover anything from collateralised swaps, senior debt on private collateralised loan obligations to export credit agency loans. We benefit from a strong reputation for undertaking large, complex transactions in short timeframes – working carefully through the due diligence process to fully assess credit risk and unlocking significant enhancements to the illiquidity premia for our clients as a result.

Q. What trends do you think are driving investor demand for private debt?

A. The largest single driver for investors into private debt is the search for yield. If you are a German insurance company getting negative EURIBOR rates, you want to work your assets where you can. Investors also like the added protections. Private debt can give a yield enhancement for equivalent credit, diversification of borrower type, and for infrastructure debt for example better recovery rates given default – all powerful arguments for investors to go into private credit.

Q. How do you think the private debt market will evolve in Europe compared to the US?

A. There are certainly significant differences between the two markets. They are in differing points in the macroeconomic cycle, and have potential differing trends in bank regulation and hence lender appetite. The infrastructure market in Europe is larger than in the US; in private corporate debt the US is larger than Europe. European markets continue to move away from the historical skew to bank lending and towards greater provision of debt by institutional investors. In leveraged loans, for example, we are seeing a trend away from covenants in the US and that is feeding through into Europe, but for private placement we don't see any material differences in the substance (legal form, structure or credit appraisal) between the two markets.

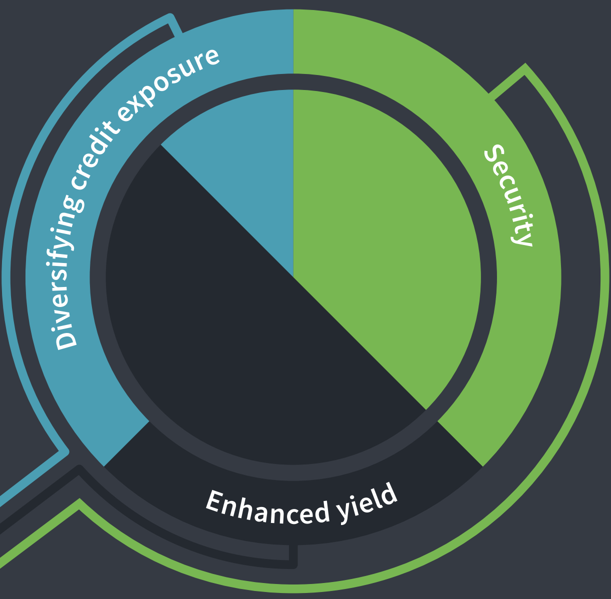
Q. After several years of spread compression in private debt, how does one balance target returns against risk?

A. Investors in private debt face the same challenging backdrop as those in public credit and equity. We do see risk premia for B and BB-rated credits at seven year lows and that is encouraging some investors into lower quality, higher yielding assets. We focus on sourcing illiquidity premia for our investors predominantly in high quality assets, and will look to take risk where we feel comfortable with it. In European infrastructure debt for example, we can find Euribor + 200-300bps for financing transport in Spain or Italy, compared to 120-200bps in the core markets (Germany, France).

Q. What regulatory trends are at the top of your mind right now, how are you preparing for them?

A. Solvency II provides a significant incentive for many insurers to invest in private debt. Similar approaches are feeding through to pension funds in how they approach risk budgeting. We are also looking at how defined contribution schemes and master trusts approach private debt; although these assets have not historically been used, they also have many characteristics which make them ideal as part of a diversified portfolio.

We are also carefully watching developments in banking regulation. Basel IV and ringfencing in the UK already appear to be causing banks to reduce their balance sheet holdings of large debt transactions, providing attractive opportunities for investors to participate in floating rate debt transactions.



Illiquidity

Friend or foe?

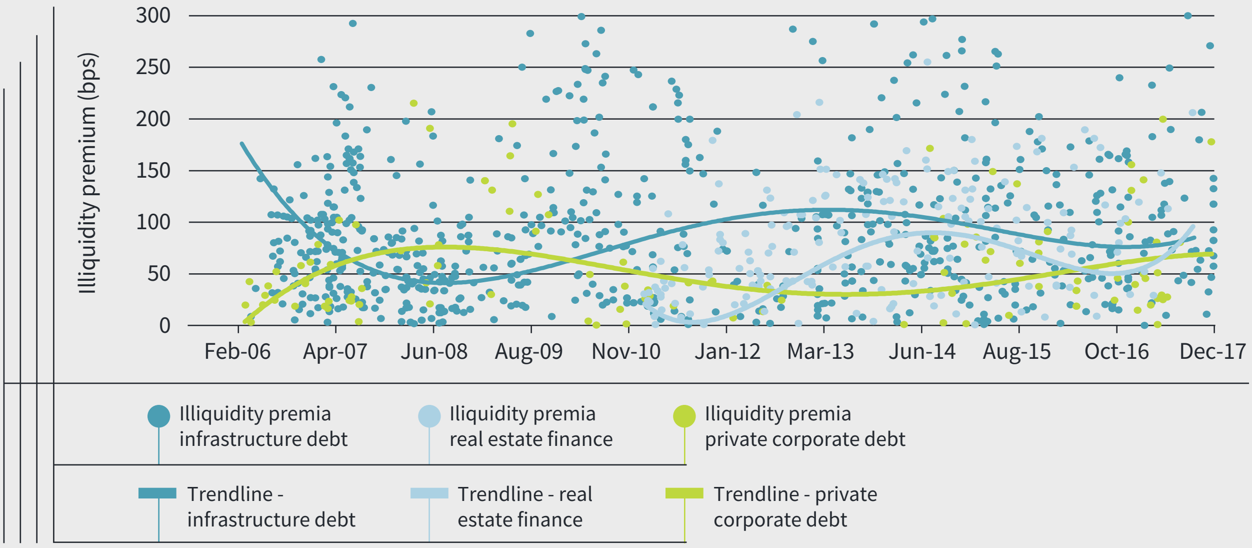
Being able to invest in illiquid assets represents a competitive advantage for pension funds as their liabilities are due over a long period, and so not all of their assets need to be instantly available.

Our study revealed that the three most commonly stated factors driving allocations for pension funds to alternative income assets are:

- Illiquidity premia, as shown in Figure 9 below.
- Diversification benefits, for example through exposure to different issuers, industries and risk premia in comparison to public markets.
- Downside protection, through being able to negotiate bespoke covenants and have asset backing, offering lower default and higher recovery rates than comparable public assets.

FIGURE 9

TRENDS IN ILLIQUIDITY PREMIA (2006–2017)



Source: Aviva Investors, data as at 31 December 2017

The three factors described above are all attractive qualities, especially given the context of those funds which are under funded, have stretched public market valuations and/or weak sponsoring employers.

While allocations to alternative income assets are expected to rise, common headwinds to increasing allocations persist, largely centred on the concerns around locking up capital for a number of years. 35 per cent of pension funds cited illiquidity as the biggest barrier to increasing their allocation, with other factors such as high cost (28 per cent) and difficulty finding suitable opportunities (27 per cent) being less important.

Concerns around investing in illiquid assets for pension funds are typically focused on the following areas:

- Restricting the ability to meeting unexpected cashflows
- Limiting the freedom to subsequently change investment strategy
- Not being able to transfer illiquid assets to an insurer as part of a de-risking strategy

1. Restricting the ability to meeting unexpected cashflows

Although pension funds can calculate their expected liability cashflows for 100 years, in reality the quantum of cashflow payable is variable. In comparison to pensioners, the variability is greater for non-pensioner members given the member choices available. Options range from a transfer of benefits to an alternative pension arrangement, taking early retirement and exchanging a proportion of a pension for cash. All of these change the cashflow profile expected to be paid in respect of a given member.

Historic data exists to ascertain the likelihood of members electing to transfer, exchange their pension benefits for cash, or take them early. However, regulatory developments can change the expected take-up of members materially, for example in the UK with the recent 'pensions freedom' changes allowing members greater flexibility on how they receive their retirement proceeds.

2. Limiting the freedom to subsequently change investment strategy

Pension schemes typically revisit their investment strategy every few years to check the overall asset allocation is still appropriate to deliver the ultimate objective. Changes in the funding position, sponsor covenant, and market outlook can lead to a revision of the investment strategy, a reflection of the scheme's prevailing position and objectives.

Where assets are illiquid, changing allocations can be difficult to implement as there can be limited opportunities to sell assets to other market participants, or assets may need to be sold at a discounted price.

3. Not being able to transfer illiquid assets to an insurer as part of a derisking strategy

Where the ultimate objective is an insurance-based solution, pension schemes have increasingly been undertaking a series of pensioner buy-in transactions, en route to a buy-out strategy; this allows risk to be managed in stages over time and increases the likelihood of achieving the target outcome.

If assets are invested in less liquid alternative income assets, there are often concerns about transferability to an insurer, agreeing valuations and being a forced seller.

How to overcome these challenges

Even with the expected rise in allocations to alternative income assets (see figure 2), a pension scheme would still has over 90 per cent of its assets available to meet unexpected cashflows, re-balance to a new investment strategy and to transfer to an insurer if appropriate. And while flexibility is perceived to be attractive, pension schemes should focus on the value of this and the materiality of any reduction in flexibility from an allocation to alternative income assets, given the attractive qualities of these assets.

Alternative income assets deliver a high degree of ongoing cashflow through regular coupons (some assets are amortising, increasing the pace of cashflow). Therefore, they can provide a high degree of ongoing liquidity which can be used to help manage the challenges highlighted – e.g. income from an alternative asset can be used to regularly rebalance the overall investment strategy.

Furthermore, while alternative income assets are less liquid, they offer a range of maturities – i.e. they are not all long dated. Given the large demand for long-dated assets (from insurers in particular), there is a large opportunity in illiquid shorter-dated opportunities (approximately five years) which can offer a higher yield premium. This provides greater flexibility as capital from maturing assets is regularly available, therefore providing regular liquidity to meet unexpected transfer values, or even to be transferred to an insurer as part of an upcoming insurance transaction.

Appetites will vary across insurers; however, some may be willing to accept alternative income assets as payment, allowing a transfer of illiquid assets from a pension scheme to the insurer. The key challenge will be in negotiating a price. What is more, where assets have been originated by an asset manager with experience of originating assets for an insurer, there may be benefit from having a common credit evaluation and pricing approach.

Nikhil Chandra | Global Investment Solutions | Aviva Investors

Spotlight on:

Understanding the drivers of illiquidity premia

Q. What do investors need to consider before investing in illiquid assets? How does investing in such assets change their investment strategy?

A. The obvious challenge for investors in private assets is the difficulty of selling such assets quickly when the need arises, particularly in times of market stress.

However, there is a larger group of factors to consider, as private assets are complex in nature. Whereas public market investing requires focus on valuation and portfolio construction, private asset investing requires much more intensive resourcing, deep relationships and on-going asset management in order to fully understand and exploit the opportunities as they arise.

The first big hurdle is the sourcing of private assets. Originating such assets is not straightforward, as such opportunities are typically only made available among a small, selective circle. Valuation becomes difficult; the relevant data is often private and there may well be selective disclosure. Comparables may be difficult to find, both in terms of the nature of operations and comparable transactions. Valuation models need to be built from scratch. When it comes to structuring the transaction, there are myriad forms of a deal and many permutations of different security packages. Making sure you have the right structure is the key to securing robust investor protections. The situation is further complicated if leverage is involved, involving a range of financial and maintenance covenants.

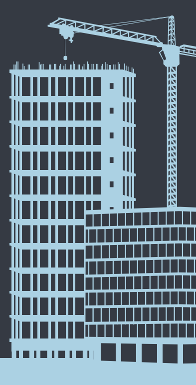
Given these complexities, investors often choose to outsource their private asset allocation to experienced managers who have wide ranging origination and deep asset management capabilities.

Q. When planning to withdraw from illiquid assets, how should investors adjust their strategies?

A. The need to withdraw from illiquid assets implies that the tolerance for illiquidity may not have been fully understood and monitored from the outset. In our view, extensive stress testing is essential to ensure that investors are not forced to make strategic shifts at short notice, potentially exposing them to liquidity shortfalls and adverse market conditions.

Instead, private assets need to be chosen with a view to achieving a certain outcome – whether that's generating long-term cash flows to match liabilities, inflation-linked revenue for real returns, or growth. With an intended outcome in mind, it is usually the case that assets are held to maturity.

Investors in private assets need to take a nuanced approach to risk. By way of example, there is a fundamentally different risk profile that comes with owning a fully-let student housing block in Whitechapel from the equity of an office block development project in Aldgate. Though you may own the equity of both, "East Central London real estate risk" reveals nothing about the nature and timing of the cash flows.



To justify inclusion of private assets in a portfolio, the key focus should be on the overall investment objectives and restrictions: do the potential return and the associated risks (including the illiquid nature of private assets) add value? For those who have the capacity and appetite to tie up capital over the medium-to-long term, private assets can offer attractive returns and enhance resilience.

Solvency II

How regulation shapes insurers' demand for alternative income

The Solvency II Directive provides a harmonised regulatory regime for insurers across the European Union. This regime drives insurance investment decisions through both qualitative requirements; and the Prudent Person Principle, and quantitative requirements; the Solvency Capital Requirement (SCR).

The introduction of Solvency II has affected insurers' perceptions of alternative income solutions – with these varying markedly across different countries. And, as Solvency II continues to evolve, we're likely to see further such changes over time.

Our study highlights that insurers across Europe have different perspectives on the implications of Solvency II for alternative income assets. Reassuringly, however, insurers investing in alternative income have strong in-house understanding of the relevant asset classes.

Implications of Solvency II

Whilst we acknowledge that the country samples when split between insurers and pension funds are relatively small, we feel there are some interesting comparisons to be made.

When asked whether Solvency II requirements are making alternative income assets more attractive:

- Over 60 per cent of insurers in France and Germany agree or strongly agree.
- Over 40 per cent of insurers in the UK and Netherlands disagree or strongly disagree.

This striking difference, illustrated in Figure 10, goes some way towards explaining the finding that Continental European insurers are targeting a larger increase in their allocations to alternative income than UK insurers. Continental European insurers are expecting to boost their alternative income assets from 6.5 per cent to 9.2 per cent. UK insurers expect a smaller absolute increase in allocation levels, from 7.3 per cent to 8.3 per cent.

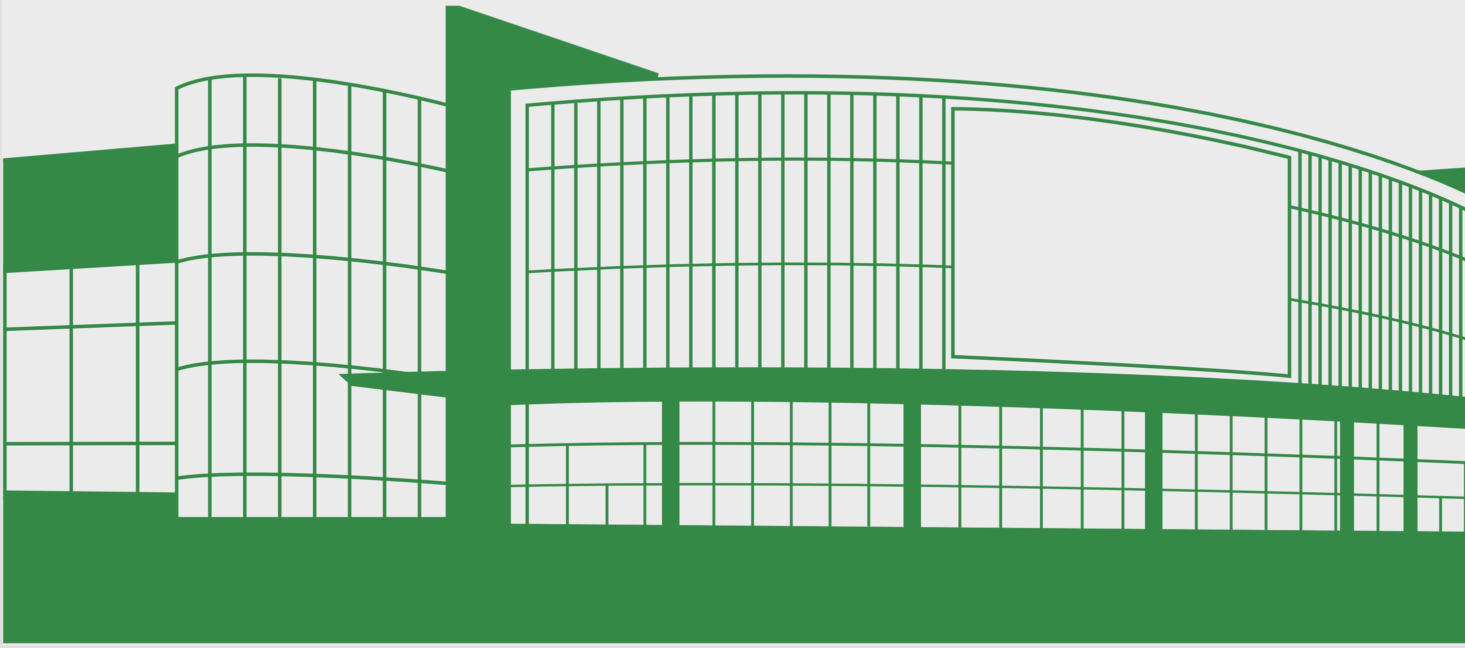
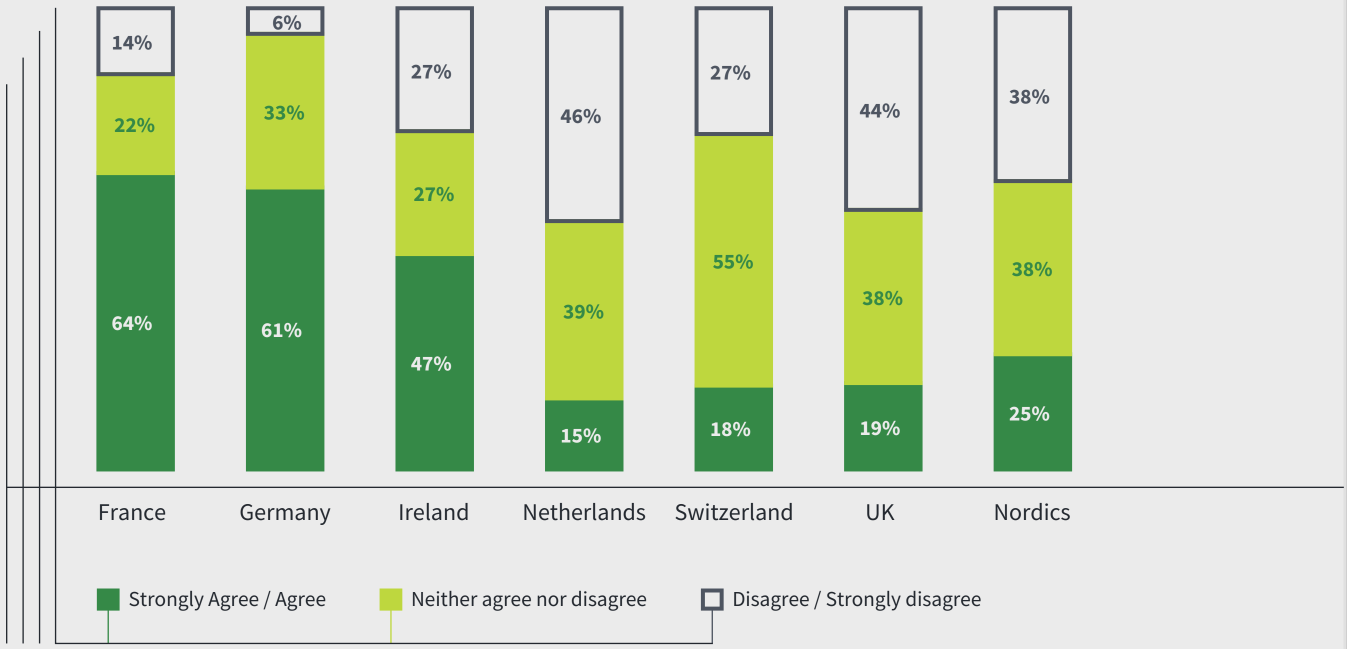


FIGURE 10
DIFFERING VIEWS ON REGULATORY CONSTRAINTS

To what extent do you agree or disagree with the following statement?

"Solvency II requirements are making alternative income assets more attractive to my insurance institution".



Under the Solvency II Standard Formula calculation, certain alternative income assets benefit from a lower capital charge, including qualifying infrastructure debt and infrastructure equity. Real estate finance can also benefit from reduced capital charges where the underlying collateral meets certain criteria.

However, given the need for 'one size fits all' treatment, the Standard Formula SCR charges are inevitably quite broad brush. For instance, the Standard Formula suggests the same capital treatment for a 75 per cent loan-to-value real estate finance loan and a 50 per cent loan-to-value real estate finance loan. And for private corporate debt, the same capital charge would apply to loans to a large, defensive corporate as a small, highly-cyclical entity.

Therefore, the risk appetite of insurers using the Standard Formula, and where they are seeking to invest within given alternative income asset classes, will influence their perceptions of how Solvency II is affecting those investment decisions.

This may be a less significant driver for insurers using internal models to calculate SCR, where a more finely tuned, risk-sensitive approach can be adopted. While there is time and cost involved in developing these models and getting the necessary regulatory approvals, ultimately they should allow insurers to adopt a more targeted investment strategy for alternative income.

Therefore, the balance between internal model firms and Standard Formula firms within a given jurisdiction may influence the perception of Solvency II for alternative income assets.

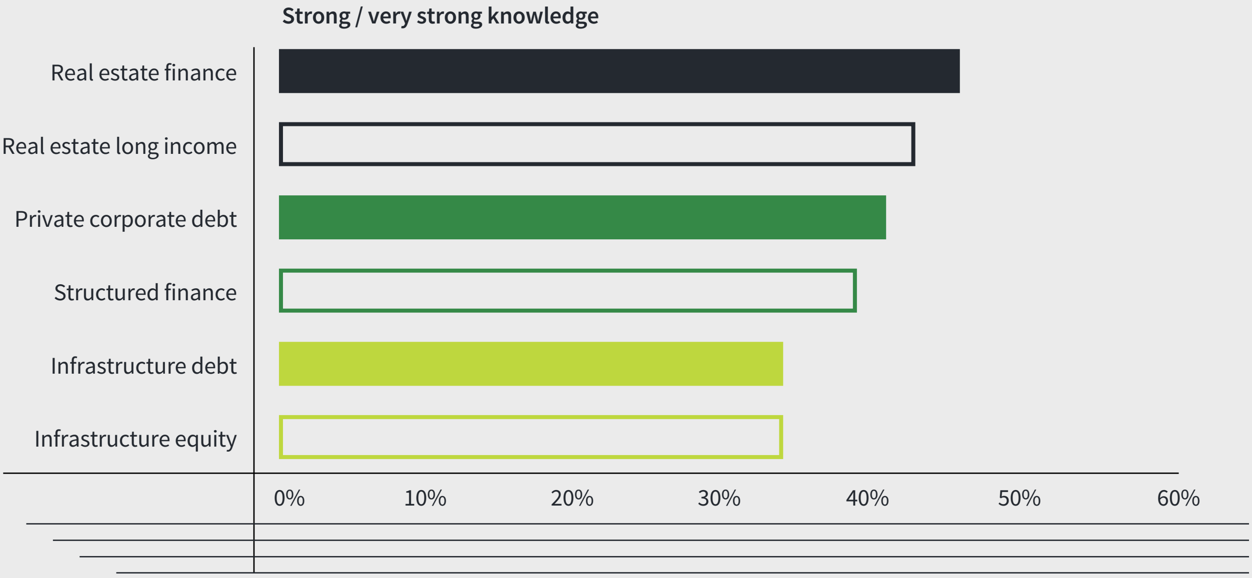
The situation in the UK also needs to consider the impact of holding alternative income assets within a Matching Adjustment portfolio:

- The Matching Adjustment provides a significant capital benefit, worth around £66bn[1] to UK insurers, which might be expected to make this group of investors more positive on the impact of Solvency II.
- However, there are stringent eligibility requirements for Matching Adjustment portfolios, resulting in significant regulatory complexity. If UK firms are comparing Solvency II to the previous regulatory regime, they would likely view Solvency II as a negative factor.

FIGURE 11

INSURERS' IN-HOUSE KNOWLEDGE OF ALTERNATIVE INCOME ASSETS

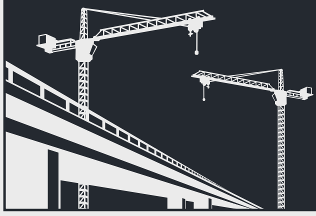
For each of the asset classes below, how would you rate the knowledge/expertise of your in-house investment team today?



[1] Source: Speech given by David Rule, Executive Director of Insurance Supervision, Bank of England: 'An annuity is a very serious business', 26 April 2018.

Our results show, reassuringly, that in-house knowledge has a significant bearing on allocation choices.

Among all the investors we surveyed:



63% of those with strong in-house knowledge of **infrastructure equity** have invested

vs **43%** of others

54% with strong knowledge of **RE long income** have allocated

vs **31%** of others

68% of those with strong knowledge of **private corporate debt** have invested

vs **47%** of others

Insurers' expertise – understanding the risks

The Prudent Person Principle under Solvency II sets out a number of requirements for insurers, notably that the firm must only invest in assets the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs.

The insurers surveyed reported having significantly stronger in-house investment expertise than pension funds across all asset classes. We have seen significant investment from insurers to build out this expertise, reflecting the increased investments in these asset classes and the requirements of the Prudent Person Principle.

Insurers reported having the strongest in-house investment expertise in real estate (both real estate finance and real estate long income) and, to a lesser extent, private corporate debt (see Figure 11).

Surprisingly, infrastructure debt, an asset class for which 31 per cent of insurers hope to increase allocation over the next three years, is one of the areas where insurers' in-house expertise is at its weakest. We anticipate that firms would seek to address this position, particularly noting the relatively attractive capital treatment for infrastructure debt under Solvency II.

Taking the plunge

How to allocate to alternative income

Our study finds that 63 per cent of investors are planning to allocate new money to alternative income strategies over the next 12 months.

However, once the allocation decision has been made, how best to access them needs to be fully considered, ranging from whether to manage the assets in-house or to outsource, through to whether to invest in single or multi-asset strategies.

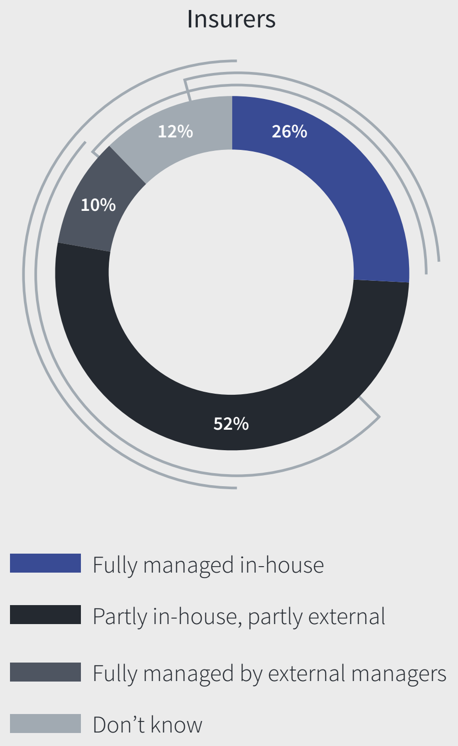
In-house vs External

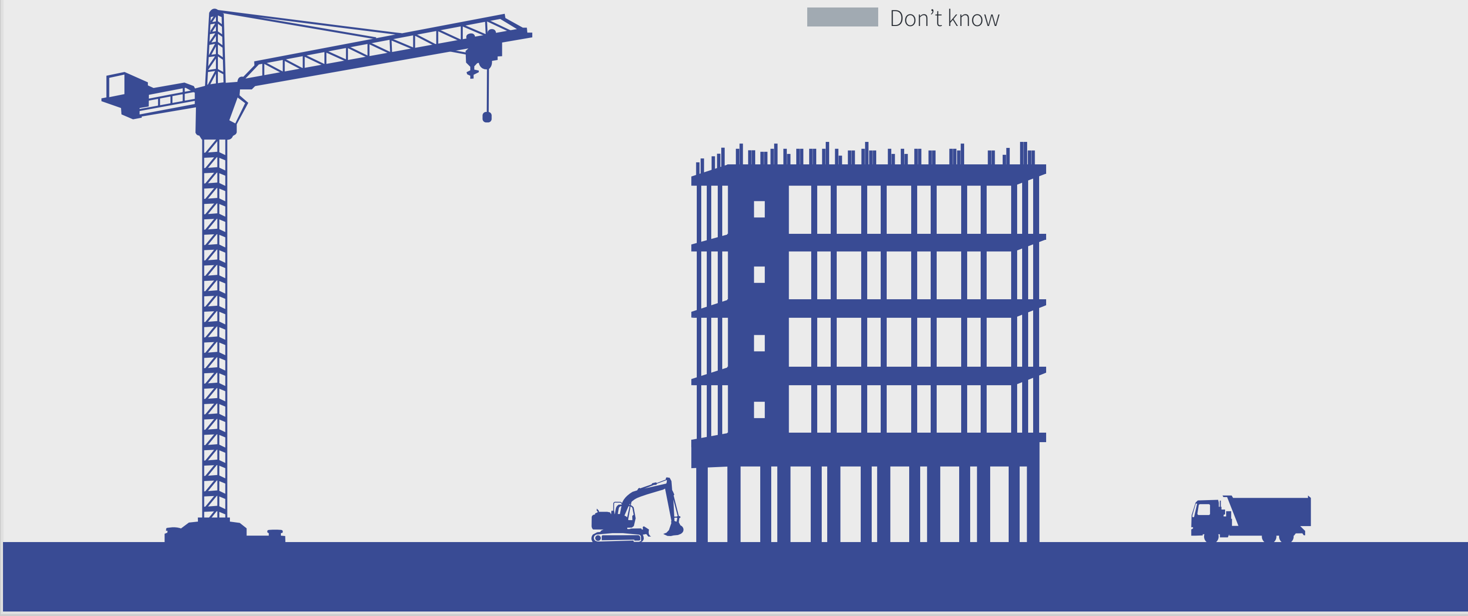
In short, it depends on the asset type. The majority of our study respondents (62 per cent of insurers and 56 per cent of pension schemes) intend to engage external asset managers – either partially or fully – to support them with their future alternative income strategies.

Despite this, there are other important factors to pay attention to when deciding upon the best approach, particularly as growing demand for some alternatives puts downward pressure on yields.

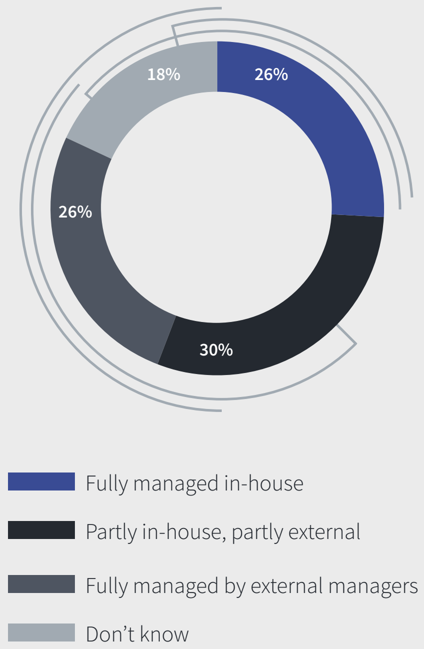
FIGURE 12
MANAGING ALTERNATIVE INCOME STRATEGIES

What would be your preferred approach for managing alternative income strategies in future?





Pension Funds



Based in the Netherlands, APG's Managing Director of Global Real Assets, Patrick Kanters, says the fund has been moving towards building its in-house team to increase direct investing in infrastructure. "It gives us the opportunity to select the investment strategy, drive down the investment costs related to fees and it gives us much more control over strategic decision making," says Kanters. "These structures often provide us with a better ability to align interests with the operators that we are working with."

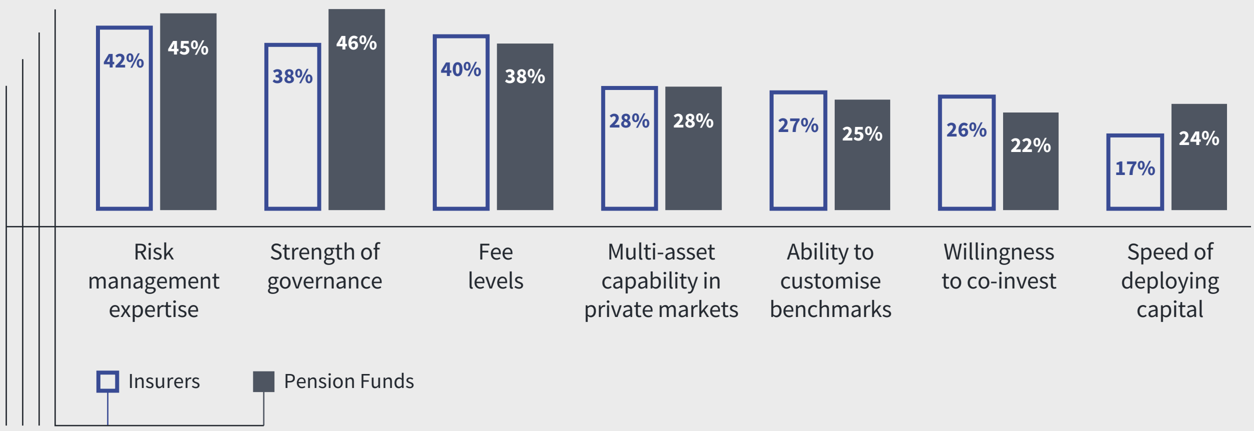
When it comes to private corporate debt, however, Mikko Mursula of Ilmarinen says he believes that engaging external managers makes more sense than opting for direct investments. "Most of the big investors out there are increasing their allocation to private debt, but it hasn't impacted returns too much yet, and it's one area where I still believe it is possible to find illiquidity premium," he says. "That's one part of our portfolio where we are outsourcing to external managers to find the most interesting alternatives out there within this asset class."

Manager selection

In selecting external managers for alternative income mandates, pension funds cited risk management and governance as being of greater importance than fee levels (see Figure 13). For both insurers and pension funds, the speed at which managers can deploy their capital is of lesser concern relative to other factors.

FIGURE 13
MANAGER SELECTION CRITERIA

How important are the following attributes when selecting an external asset management partner for alternative income investments?



"The arrangements need to be equitable but you still need to incentivise a manager to manage, so there's a delicate trade-off between the fee and the hurdle rates — I think hurdle rates need to be set in line with the lower risk return that could be obtained from that asset, and then you look at where the skill is in adding value," explains Nick Greenwood, Pension Fund Manager of the UK's Royal Borough of Windsor and Maidenhead's Pension Fund. "If you take residential real estate as an example, the added value from the manager is in ensuring that voids are low, that rents are allowed to grow and that the properties are kept in prime condition. So the conversation really is, how do I make sure that I incentivise you correctly to meet those three criteria?"

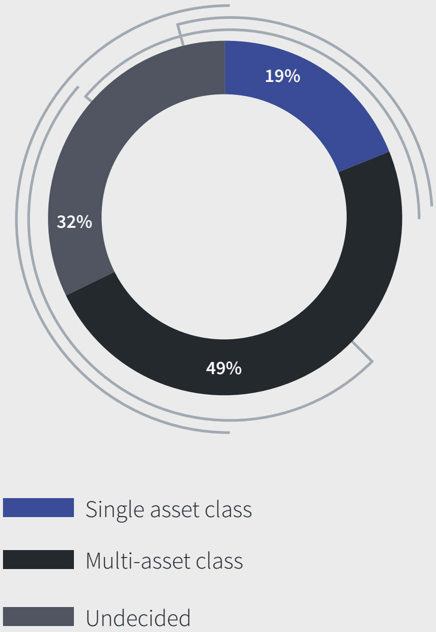
Multi-asset vs. single asset class

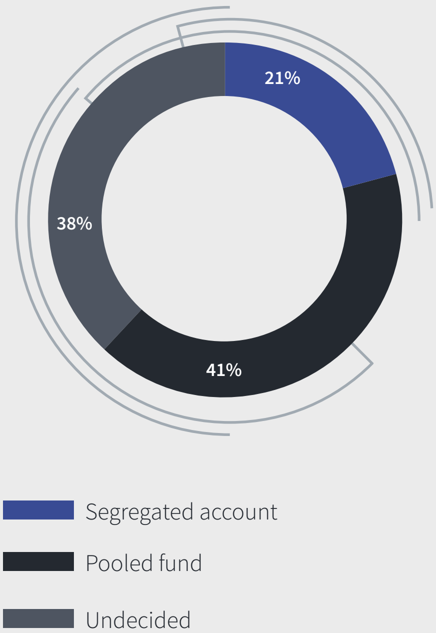
The institutions we surveyed are more likely to prefer multi-asset over single asset class investments, and pooled funds over segregated accounts, when they embark on new alternative income investments (see Figure 14).

Such a preference for multi-asset allocations points to a lack of confidence from investors in what they likely consider new territory for them. As familiarity and expertise grow we would expect to see an increase in investment via single strategies.

FIGURE 14
INVESTORS LOOK TOWARDS MULTI-ASSET AND POOLED SOLUTIONS FOR ALTERNATIVE INCOME STRATEGIES

If you were to enter new alternative income investments in future, what do you think would be your preferred choice between the options below?





Interestingly, even among the largest investment institutions in our study, pooled funds are preferred to segregated accounts: 38 per cent of investors with assets under management of $20bn or more prefer pooled funds, while only 21 per cent would opt for a segregated account.

This approach has clear advantages for institutions that are seeking to accelerate the path to diversification. “With institutions committed to diversifying across asset types, fund structures offer an expensive but valuable way to reduce risks across the portfolio, and to ensure that responsibilities are assigned to the most skilful parties,” says Gilles Lafleuriel, Head of Real Assets and Alternatives at Nordea Wealth Management (which serves Nordea Life and Pensions).

Every investor will be different and have a unique starting point in terms of their DNA and overall expertise in certain alternative income areas. One size will not fit all and the key will be in finding investment partners that complement areas of in-house strength and are also able to provide bespoke advice.

As Robert McElvanney, Senior Investment Strategist of the UK’s Santander AM, put it:

> “There are opportunities for long-term investors who can provide liquidity and step in where banks have had to withdraw for regulatory reasons. As long as you understand what it is you’re taking on, and can assess which investment managers out there have the skills and capability to identify the opportunities and negotiate the correct contracts, it’s a very interesting place for long-term investors.”

A dual perspective on the draw of co-investment

John Dewey, Head of Investment Strategy for Global Investment Solutions at Aviva Investors, notes that institutional investors are increasingly interested in exploring co-investment opportunities in the private asset space.

“Investors draw a lot of comfort from the fact they’re co-investing alongside Aviva — we often have skin in the game from our insurance parent. There’s a clearly defined policy that we have to adhere to for how transactions will be shared, so that investors can access the strong deals that Aviva has access to,” he says.

“This is something that is seen as a really attractive element of what we do. And, again, it gives investors access to larger assets, different types of assets, and allows clients to build a portfolio that wouldn’t be possible to achieve on their own.”

Marcus Pauli, CIO for Alternative Investments at KEVA (Finland’s largest pension provider), echoes this:

“Many large investors are trying to increase their allocation to alternatives and especially less liquid assets like private equity and infrastructure. We have to fight really hard nowadays to get allocations from private equity funds or the better infrastructure deals”, says Marcus.

Niren Patel | Global Investment Solutions | Aviva Investors

Spotlight on:

Mapping opportunities in private markets

Most alternative assets trade infrequently and do not have a close parallel in public markets, but a pragmatic approach to valuations can give a deeper understanding of how an asset is expected to perform, both in absolute and relative terms.

One way to do this is to compare private deals to a public benchmark, adjusting each deal spread to give a reasonable comparison with the benchmark's characteristics. Adjustments can be derived from data sets of spreads on corporate non-financial bonds with different ratings profiles. Typically, the publicly-traded asset used as a comparator is not as liquid as risk-free assets, and may provide some reward for illiquidity as well.

Drilling down in this way reveals the range of premia available across different asset classes. Recently there has been some spread compression, particularly for assets that meet the specific regulatory requirements for insurers writing annuity business. Here, competition has been intense for higher yielding assets that meet the restrictions imposed by Solvency II's Matching Adjustment framework. Nevertheless, the rewards for taking illiquidity risk persist.

Picking suitable assets

There are a number of opportunities that might be attractive for institutional investors, particularly as Basel IV already seems to have precipitated some balance sheet restructuring in the banking sector. Certain banks are looking to reduce their holdings of large debt transactions, freeing up capacity in floating rate deals, some of which are becoming available at a discount to par.

Another area of change is in fund financing. Here, a growing number of funds are lending to SMEs (companies with EBITDA of around £20m to £50m), and seeking to raise finance to bridge the gap between identifiable opportunities and the receipt of funds from investors. Fund financing can offer an attractive risk/return profile while the lender potentially retains a degree of control over which companies the funds lend to.

For clients with derivative hedging requirements, there are opportunities to trade uncollateralised swaps; some corporates need swaps but do not have sufficient liquid collateral to support them. Banks have limited appetite for uncollateralised swaps, given their existing capital requirements. This scenario is creating opportunities for investors to trade swaps with corporates directly, rather than through a bank counterparty.

For insurers, there may be potential in real estate financing, including providing longer-dated loans with terms stretching over 10 years, as well as opportunities in long-lease commercial real estate (including student accommodation and social housing), ground rents and equity-release mortgage loans. These assets could be used in long-term savings business, such as with-profits, to back long-dated general insurance liabilities or within shareholder funds, backing the on-going capital requirements of the business.

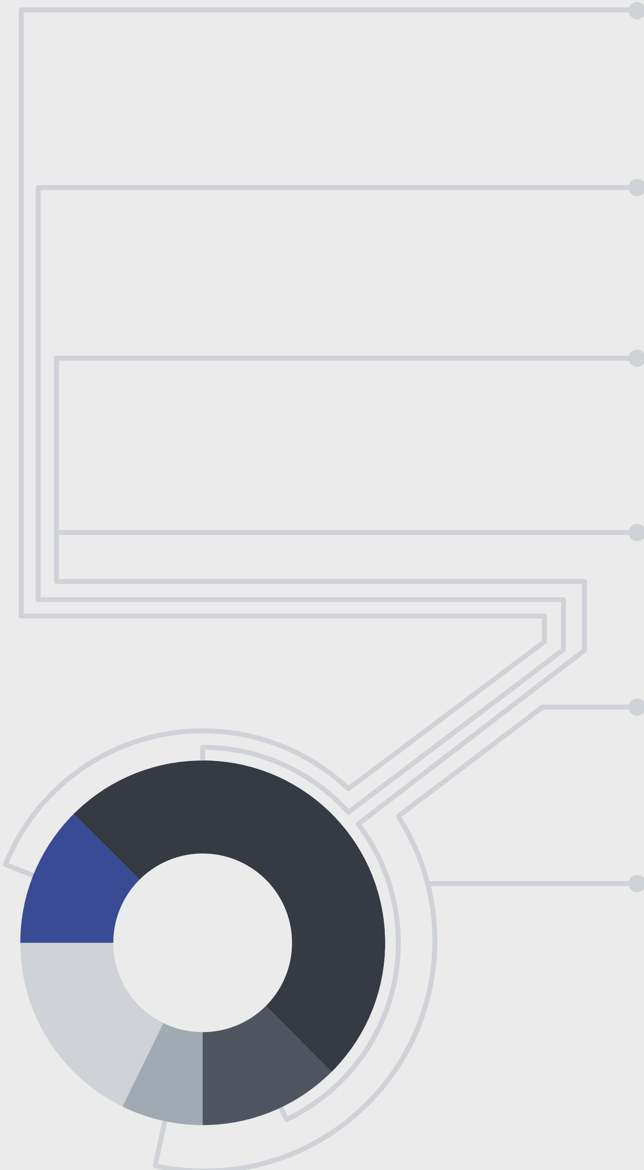
Appendix

Risks and Definitions

Risks: Illiquidity
Alternative Income assets are significantly less liquid than assets traded on public markets. Where funds are invested in infrastructure/real estate, investors may not be able to switch or cash in an investment when they want because infrastructure may not always be readily saleable. If this is the case, we may defer a request to redeem the investment.

Valuation
Investors should bear in mind that the valuation of real estate/infrastructure is generally a matter of valuers' opinion rather than fact. The value of an investment and any income from it may go down as well as up and the investor may not get back the original amount invested. Past performance is not a guide to future returns.

Definitions of alternative income asset classes included in this study are:



INFRASTRUCTURE DEBT
Loans to finance the construction of long-term facilities (e.g. buildings, roads, power supplies) that underpin economic activity.

STRUCTURED FINANCE
Bespoke opportunities in asset financing, corporate financing and public sector financing.

INFRASTRUCTURE EQUITY
The capital or equity owned by investors in infrastructure projects; includes unlevered (owning the whole project without associated debt).

REAL ESTATE FINANCE
Loans to assist in the purchase or refinancing of commercial real estate (e.g. offices, retail, industrial, logistics, leisure and healthcare facilities).

PRIVATE CORPORATE DEBT
Privately-issued debt via private placements or bilateral loans to borrowers ranging from investment grade to privately-owned corporates.

REAL ESTATE LONG INCOME
Long-lease commercial real estate let to public sector or corporate tenants; sale and lease back, income strips and ground rents.

Find out more:

If you wish to know more about our Alternative Income Solutions, please contact your usual representative or our Global Client Solutions team:

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