RESEARCH REPORT

Are allocators driving impact in the private markets?

Contents

1. Executive summary **3**

1. Two key takeaways 4
2. Relevance to ESG investing 4
3. Allocations at a nascent stage 5
4. ESG investing is not plain sailing 5
5. Future growth will depend on the relative strength of opposing forces 5
6. Asset managers need to up the ante 6

2. An intrinsic alignment **7**

1. ESG investing is driven by a multiplicity of approaches 7
2. A potential win–win 7

3. ESG allocations are at an early stage **9**

1. ESG investing targets multiple goals 9
2. Modest allocation levels 10

4. Private markets have their own downsides **11**

1. Constraints related to pension plans 11
2. Constraints related to private equity and private debt as asset classes 12

5. The winds of change in private markets **13**

1. Drivers affecting pension plans 13
2. Drivers affecting private equity and private debt 14

6. Manager selection is key **15**

1. Baseline criteria 15
2. ESG differentiators 16

7. Conclusion **17**

Acknowledgements **18**

1. Executive Summary

Introduction and aims

This report presents the results of a global survey of pension plans. It aims to find out the main thrust of their approach to investing in environmental, social, and governance ("ESG") factors with respect to two private market asset classes: private equity and private debt.

ESG investing is defined here as the integration of individual ESG factors into the investment process and/or the stewardship process of general partners who seek to harvest the embedded factor premia in their portfolio of companies.

Our survey pursued five questions:

- How suitable are private equity and private debt for ESG investing?
- What is the current allocation to them by pension plans worldwide?
- Which factors have served to slow allocations?
- Which factors are likely to drive allocations over the next three years?
- How do asset managers of private equity and private debt need to up their game to attract higher allocations in future?

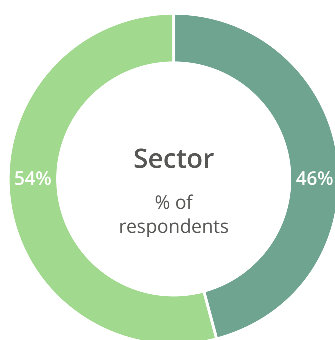
The survey is timely. The early phase of ESG investing took root in public markets and has since spread into private markets. This survey highlights the dynamics of that broader advance, the challenges that have been encountered and the solutions they require.

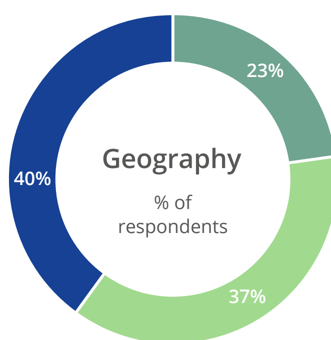
This report has relied on information from a global survey of 152 pension plans in three key regions: Asia-Pacific, Europe, and North America. It involved senior decision makers in the area of asset allocation during the summer of 2023. They cover a broad spectrum along three dimensions in the charts below:

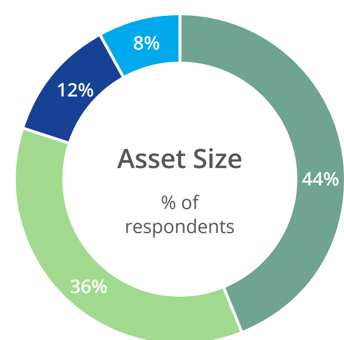
- Sector: the public sector plans have a higher weighting, in line with their higher share of global pension assets.
- Geography: North America and Europe have higher weightings to reflect the main domicile of global pension assets.
- Size: the sample captures a broad spectrum of plans, including large plans who have been the early movers in private market, and small and medium sized plans who are now seeking to follow them.

The rest of this section provides the survey's key findings on the five questions posed. All the quotes cited herein emerged from the survey participants.

Characteristics of survey respondents in terms of sector, geography, and asset size







Source: CREATE Survey 2023

Key findings

> *"Private markets will continue to attract ESG capital from pension plans, but only for as long as asset managers deliver on their clients' ESG goals"*
>
> An interview quote

1. Two key takeaways

ESG investing across many asset classes – especially in public markets – suffered a performance setback in the bear market of 2022. Many ESG funds suffered underperformance of roughly 3 to 4 percentage points compared with broad equity markets in 2022, according to Oliver Wyman analysis (Financial Times, August 7, 2023). Yet, our surveyed pension plans continue to see ESG integration as a foundational trend – not just the bull market luxury its critics have long claimed (Figure 1, left chart). The setback is viewed as a part of a larger macroeconomic dynamic that has little to do with ESG per se.

Pension plans believe that ESG investing can withstand volatile markets while pursuing long-term societal benefits as well as good risk-adjusted returns. Allocations to private debt and private equity are set to rise over the next three years in Europe, the U.S. and to a much lesser extent Asia-Pacific (Figure 1, right chart). However, the recent performance setback has raised the burden of proof, demanding clear proof points that ESG investing works in public and private markets alike. Hence, manager selection criteria are far more exacting. They demand a fresh narrative from asset managers on where they stand on ESG goals and what they can meaningfully deliver.

2. Relevance to ESG investing

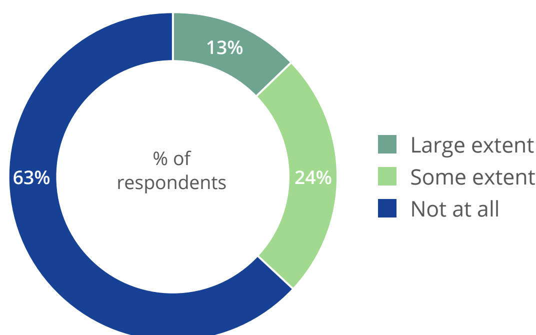
Both private equity and private debt are seen as intrinsically suitable for ESG investing by the large majority of our survey respondents, as they strive to turn corporate ESG laggards into leaders.

Specifically, private equity investing is seen as highly conducive to ESG integration as well as impact investing, given its longer time horizons and active ownership. Impact goals are typically hardwired into fund mandates. This allows pension plans to exercise more effective stewardship of firms in the fund.

Private debt is also seen as being ideally suited for impact investing, with its longer time horizons and the inclusion of ESG covenants into legal agreements, including those that deal with the stranded assets created by action against global warming. Private debt is also ideally suited to fund UN Sustainable Development Goals ("SDG") related projects as well as provide working capital for grassroots-impact businesses.

(More details in Section 2)

To what extent has ESG investing been a bull market luxury that cannot withstand volatile markets going forward?



How are allocations to ESG-related funds likely to change over the next three years?

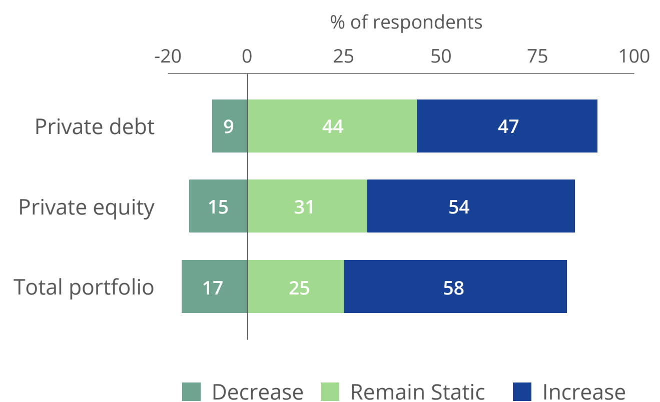


Figure 1. *Source: CREATE Survey 2023*

3. Allocations at a nascent stage

Both private equity and private debt are seen as ideal vehicles for delivering the ESG goals set by pension plans, such as a triple bottom line (doing well financially, helping the environment, and doing good socially) and the control of fat-tail/far-off risks. However, the advance of ESG investing in private equity and private debt portfolios is still at a nascent stage. But it has been gaining traction in this decade, via ESG integration, impact investing, and stewardship routes at varying rates. As shown in Figure 3 in Section 3, in private equity, 24% of respondents have no ESG allocations, 57% have allocations of up to 5%, and 19% have allocations of over 5%.

In private debt, 34% have no ESG allocations, 57% have allocations of up to 5%, and 9% have allocations of over 5%.

With regard to geography, the biggest allocations of ESG assets are skewed towards the U.S., thanks to its less restrictive M&A rules. The biggest allocations are also skewed towards large pension plans, the accounting rules of which make private equity assets more attractive.

Private debt's floating rate is also seen as offering protection against rising interest rates and inflation. Overall, both private equity and private debt have so far offered opportunities to diversify into new ESG-based business models – designed to deliver specific ESG benefits like renewable energy – that are key sources of value creation in the global economy.

(More details in Section 3)

4. ESG investing is not plain sailing

The advance of ESG investing into private equity and private debt has thus far been somewhat constrained by two diverse sets of factors, some related to pension plans and some to the two asset classes themselves.

Taking them in turn, some pension plans are not tooled up with the governance and skills sets required to venture into long-horizon illiquid assets. Some have attained good funding status due to rising interest rates, allowing them to perform insurance buyouts. Some have suffered from the 'denominator effect', as the 2022 bear market hit liquid assets disproportionately and artificially raised the share of private market assets from their strategic weights in asset allocation. Some worry about greenwashing, which treats ESG as a marketing gimmick. Some worry about the latest political backlash against ESG in the U.S. – the world's largest source as well as the destination of private equity and private debt funds.

In turn, constraints holding back ESG allocations related to the two asset classes include their high fees and charges over long time horizons; wide dispersion in their reported returns; a lack of transparency around ESG processes and performance evaluation; a prevalence of high levels of 'dry powder', and, above all, worries about a credit crisis, if rates in the key economies remain higher for longer.

(More details in Section 4)

5. Future growth will depend on the relative strength of opposing forces

Looking three years ahead, allocations are set to rise. Certain drivers will promote asset growth, others will act as a drag on it. A key driver will be the intensified search for high returns in what is likely to be a low-return environment, in which central banks' easy money policies of the past decade have borrowed against future returns.

Other drivers include: regulators relaxing liquidity rules in the fast-growing defined contribution markets in Europe; the shrinking of equity of public markets reducing opportunity sets; and the improving bargaining power of limited partners as rising interest rates jack up the cost of leverage for asset managers in private markets.

Drivers directly helping private equity and private debt investments include an expanding universe of growth companies preferring to remain private for longer and the end of the era for public equities.

However, two big unknowns may well slow future growth: whether the U.S. Federal Reserve can engineer a safe landing that reduces inflation risk and recession risk; and what the real impact of the latest regulatory reforms on private equity from the U.S. Securities and Exchange Commission ("SEC") will be. These aim to influence the nature of terms that are permissible in investment mandates.

Most likely, the U.S. will remain the focal point of private equity and private debt assets but their growth engines will be Asia-Pacific and Europe, as the industry faces its toughest set of operating conditions yet in the U.S., its biggest market. This applies to private equity and private debt assets in general. As far as ESG investing is concerned, growth will be more pronounced outside the U.S.

(More details in Section 5)

6. Asset managers need to up the ante

Widespread media publicity over greenwashing among some of the top long only managers in public markets has turned manager selection in all markets into a far more robust due diligence process on key factors at two separate levels.

The first covers investment basics such as: a value-for-money fee structure in the expected low-return era; greater transparency around all the business processes in the value chain; and the stability of the talent pool across the life cycle of individual deals. In contrast, the second level covers aspects that create a competitive edge over business rivals. It includes a proven track record of delivering clients' ESG goals, as ESG is now a fiduciary duty for most pension plans.

To ensure that a manager's enviable track record has a high likelihood of being replicated in future, ESG values need to be embedded in the corporate DNA of asset managers. In particular, their business leaders have to 'set the tone at the top' by linking executive compensation with ESG targets and ensuring that stewardship reports provide narrative disclosures: real-life stories and concrete examples of the challenges, actions, and outcomes on the ground that lie behind the dry numbers on ESG progress. After all, from an investor standpoint, ESG is about creating businesses of enduring value for their four key stakeholder groups: shareholders, employees, customers, and the wider society. To achieve this overarching goal, pension plans now look to their general partners to assist in three ways.

The first is to help towards delivering reliable qualitative and quantitative data on corporate ESG scores that are independently audited, so that ESG decisions have a robust base. The second is to exercise the stewardship role in a way that generates rich insights on how the ESG story is playing out on the ground, so that pension plans can develop an information edge that generates alpha. The third, and most important, is to run with the grain of the structural dynamic that is morphing ESG investing into fundamental investing, so that markets are finally able to price negative externalities (Case study 1). Laser-sharp focus on these areas by managers of private equity and private debt will give much-needed fresh impetus to the current ESG allocations.

(More details in Section 6)

CASE STUDY 1 As capital markets price in negative externalities, ESG will morph into fundamental investing

A Canadian pension plan

With the 2015 Paris Agreement on climate change came growing acceptance that corporate balance sheets need to factor in negative externalities: those uncompensated costs inflicted by corporate activities on wider society that do not feature in their own P&L statements. These externalities are increasingly being passed back on to corporates in the form of costs, due to social pressures, and governmental action. Thus, polluters are bracing themselves for rising operating costs in place of previously unaccountable environmental damage. Lately, the regulatory and policy tempo has finally caught up with a trend that has been around for over 15 years. As governments and regulators have turned the spotlight on ESG factors, ESG investing has gone from niche to mainstream, selectively pricing in climate risks. Similarly, in the 'S' pillar, diversity, equity, inclusion, and respect for human rights are closely linked with value chain resilience and business stability.

Such developments are set to change the whole ecosystem of capital markets, which has hitherto remained focused on short-term financial goals, irrespective of the damage they may inflict. Risk models based on past price performance are now akin to driving a car by looking at the rear-view mirror. This emerging consensus is also backed by a raft of regulation from Australia, Canada, China, India, Japan, the EU, and the U.S. in areas such as green taxonomy, product labelling, and mandatory disclosure of ESG data from listed companies. This is happening to the point at which regulators are emerging as the key drivers or, at least, facilitators of ESG investments.

Thus, by the end of this decade, ESG investing will be indistinguishable from fundamental investing that focuses on 'fair' market value, taking into account all risks and return drivers, not just the financial factors.

> *"Over half of the total funds raised in private markets in the banner year of 2021 flowed to general partners with formal ESG policies."*
>
> An interview quote

1. ESG investing is driven by a multiplicity of approaches

Around 35% of pension assets represented by our sample now have overt ESG goals, according to our survey. They are pursued by one or more of five investment approaches (Figure 2, left chart).

Topping the list is stewardship and proxy voting (66%). They are about managing assets prudently by directly engaging with investee companies and exercising voting rights, filing shareholder resolutions, having a say on lobbying activities and fostering a year-round dialogue on ESG issues as much as on business strategy. This form of shareholder activism is seen as a new linchpin and is as consequential as asset allocation decisions. It marks the birth of a new investment belief (Case study 2).

The next three approaches are directly rooted in the investment process. The first relies on companies with high or – even more importantly – improving ESG scores (52%). High scores mean proven business models. Improving scores, in turn, signal the potential for high alpha. The second approach relies on the integration of ESG risk and opportunities into the investment process that underpins strategic asset allocation (49%). The third approach relies on negative screening, which excludes companies engaged in harmful activities like environmental pollution, poor work relations or lax business governance (41%).

The final approach covers impact investing (37%). It targets a triple bottom line: doing well financially and doing good socially and environmentally. No longer confused with philanthropy, it is defined by the three pioneering concepts of ESG investing: materiality, intentionality, and additionality, which feature high in the manager selection criteria discussed in Section 6.

Materiality assesses whether an ESG factor is material to a company's business performance. Intentionality appraises whether it intends to pursue ESG goals as a result. Additionality assesses the extent to which desirable outcomes would not have occurred but for that investment. The primary sources of additionality are the application of leading technologies or innovative business models, or meeting the needs of underserved populations, or transforming unsustainable business models into green ones and investing in companies that are scaling carbon reduction technologies.

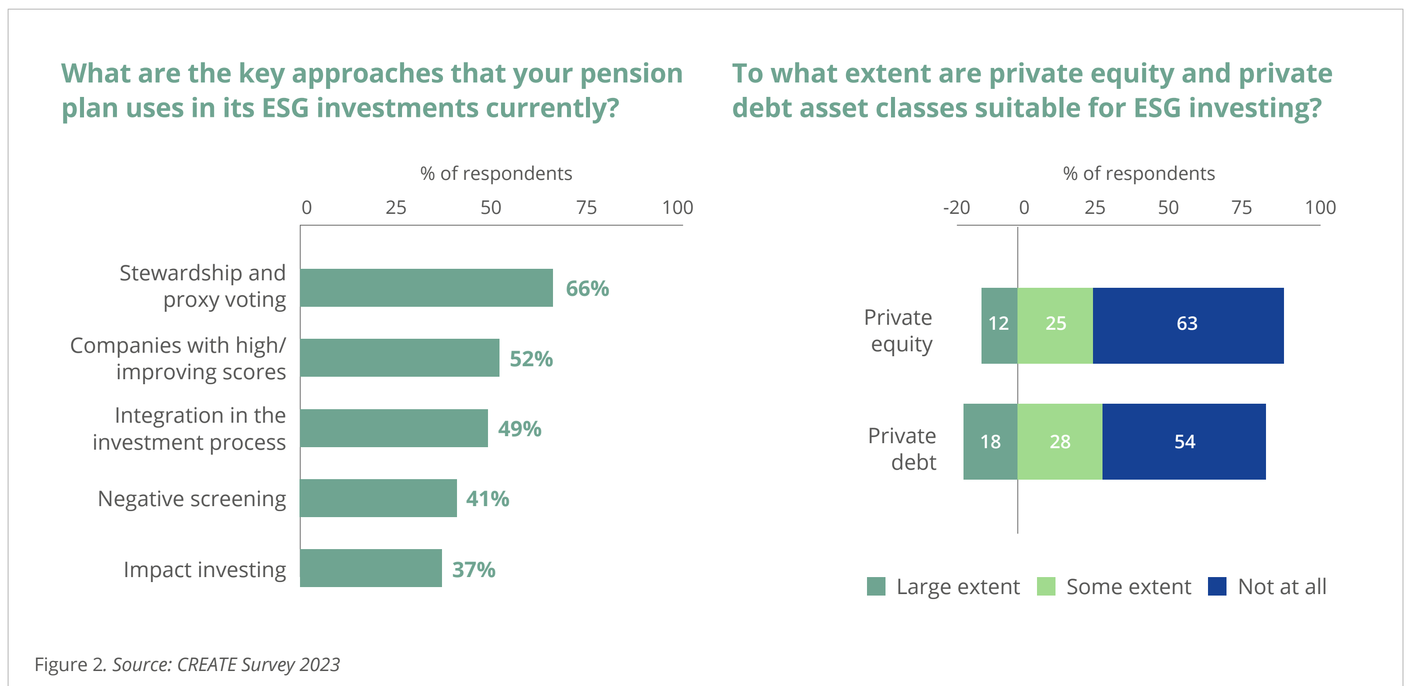


Figure 2. *Source: CREATE Survey 2023*

2. A potential win–win

Setting these approaches to one side, the intrinsic features of private equity and private debt indicate that they are ideal for ESG investing (Figure 2, right chart). For private equity, 63% of survey respondents view it as a suitable asset class for ESG investing to a large extent and 25% view it as such to some extent. The respective figures for private debt are 54% and 28%.

For private equity, those features include a range: from venture capital, working with early-stage companies that possess good ideas or technology; to growth equity, providing capital to expand established private businesses often by taking a minority interest; all the way to large buyouts, where the private equity firm buys the entire company and runs it under active ownership. This combination of ownership and control is seen as a key driver of returns. It also encourages private equity firms to acquire, add value, and then exit within the lifetime of the fund at the appropriate time. Exit strategy planning is critical for general partners.

From an ESG standpoint, these features offer investors access to emerging business models from innovative companies at the cutting edge of delivering environmental and social value. Private equity is also highly conducive to impact investing, given its longer time horizons and active ownership. Impact goals are typically hardwired into fund mandates. This not only allows investors to have stronger stewardship of targeted companies than is possible for shareholders of listed companies, it also gives them the timely information needed to steer a company in the right direction.

Private debt is also ideally suited for impact investing, with its longer time horizons. It is able to fund SDG-related projects as well as provide working capital for grassroots impact businesses – all within a senior or junior fund structure that requires companies in the fund to achieve positive evidence-based impacts during the holding period. Unlike private equity, private debt loans do not seek to own the companies. These loans emerged off the back of post-2008 regulatory changes that forced traditional banks to withdraw from structured corporate lending.

Another key goal is to prevent the risk of stranded assets, which forces companies to write off their assets ahead of their economic life as they tackle global warming. Private debt provides the necessary guardrails by writing ESG covenants into legal agreements that require the reporting of certain ESG metrics or identifying specific metrics for a borrower to improve upon and providing incentives to achieve these. They could include improving the energy performance rating of commercial buildings.

Overall, compared with other asset classes, stewardship opportunities are significantly more plentiful and effective in private equity and private debt, given the greater requirement for due diligence and ongoing active engagement.

CASE STUDY 2 Universal owners seeking to turn ESG laggards into ESG leaders

A Swedish pension plan

Over the past three decades, the twin rise of global development and technology have delivered huge benefits. But on the flip side, such benefits have accrued to many in their role as consumers but not necessarily as workers or citizens. Indeed, many Western nations have seen a hollowing out of middle-class jobs and rising income inequalities. Easy monetary policies in the last decade have delayed long-overdue reforms in education, training, and industrial policies. They are giving way to competitive devaluation policies under rising populism.

As owners of shares in a company, we are not legally responsible for its actions. But that does not absolve us of our moral responsibility when its activities inflict uncompensated harm on society – via environmental pollution, human rights violations in supply chains. As 'universal owners', we have economic stakes in thousands of companies, so we are indirectly responsible for the detriment caused by their operations in pursuit of profit. As a result, we use our financial clout to engage with the ESG laggards in our portfolios in order to convert them into leaders. Our current focus is on hard-to-abate industry sectors like steel and cement.

In the process, our stewardship activities also aim to improve the quality of our alpha and beta assets. It enables us to act as owners of businesses, not just holders of paper assets.

3. ESG allocations are at an early stage

> *"We need assets with contractual income as our pension liabilities are fast maturing."*
>
> An interview quote

1. ESG investing targets multiple goals

Before looking at current allocations, it is worth highlighting the goals that pension plans have set for their overall ESG investments (Figure 3, left chart). Some focus on returns, some on societal impacts, and some on risks. Some focus on all three.

On the return side, the most widely sought benefit is good risk-adjusted long-term returns (58%). Emphasis on the long term reflects the view that ESG is a buy-and-hold game far removed from short-term fluctuations. Emphasis on good returns reflects the fact that up to 40% of pension plans currently have funding deficits that need to be plugged.

On the societal side, 50% are also targeting a triple bottom line: doing well financially, and doing good socially and environmentally. The implied duality underlines the most distinctive feature of ESG investing and makes it stand out from traditional investing, which is focused only on financial gains.

On the risk side, three overlapping benefits are sought: 48% target a defensive portfolio that seeks to reduce fat-tail/far-off risks; 41% target good diversification and 40% target lower volatility.

This is because, as the majority of defined benefit plans now enter the decumulation phase, capital conservation and income generation have become vital. Two recent events – Covid-19 and the war in Ukraine – have shown how low-probability/high-impact events can emerge from nowhere and ravage portfolios – leaving less time for subsequent recovery.

The collapse of the Pacific Gas and Electric Company in the U.S. also showed, all too clearly, that valuation mirages can often conceal risks that were hiding in plain sight.

Based on past price performance, today's risk models are slow in factoring in future events that have no historical precedents. The Volkswagen emission-cheating scandal in 2014 showed how governance risks can emerge as a bolt from the blue. Covid-19 has turned the spotlight on how inequalities can erode the very foundations of capitalism. It is little wonder, therefore, that the key risk measure for pension plans is no longer the long-prevailing standard deviation of returns but the permanent impairment of capital.

These considerations have had an influence on current ESG allocations to private equity and private debt.

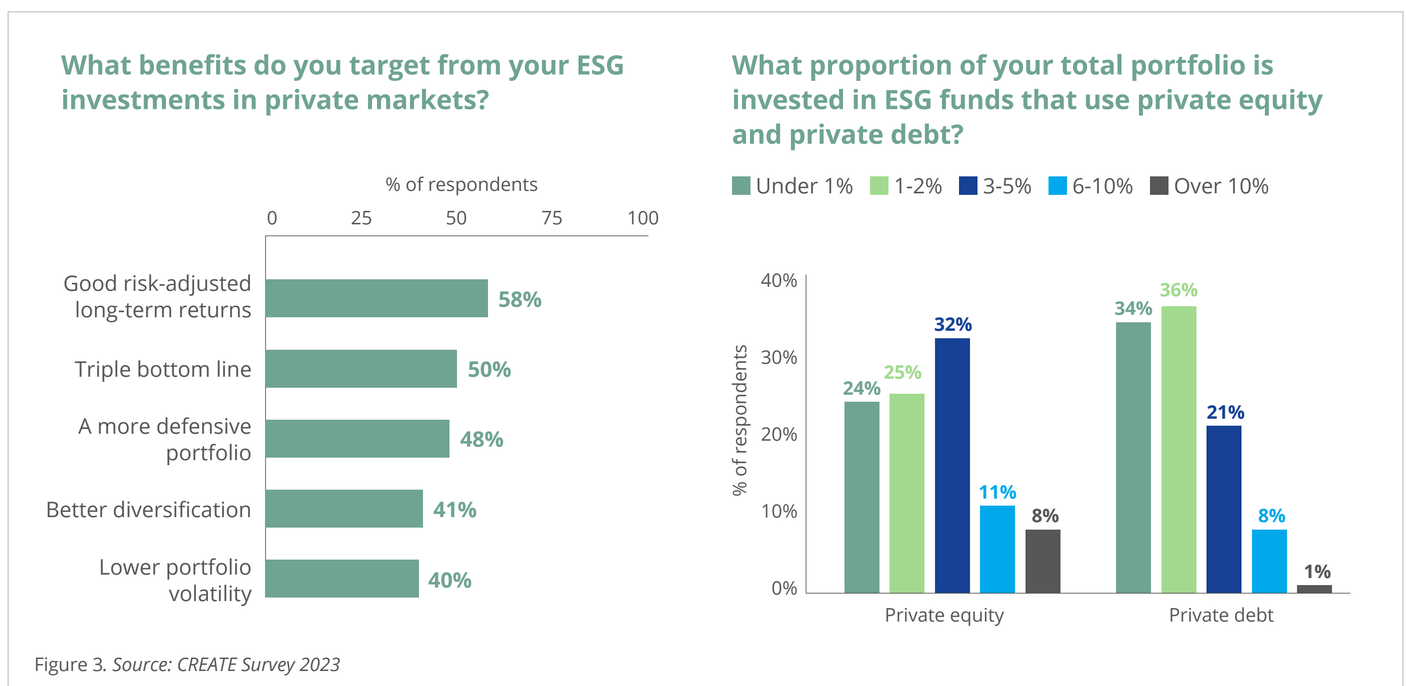


Figure 3. *Source: CREATE Survey 2023*

2. Modest allocation levels

ESG investing, in its current form, started in the 1980s with the boycott of companies dealing with the apartheid regime in South Africa. It went on to be duly integrated in 2006, when the principles of responsible investing were first adopted. But it only gained serious traction after the 2015 Paris Agreement on climate change. Its early incursion into pension portfolios started with public markets before spreading to private markets. Currently, both private equity and private debt have attracted varying levels of ESG allocations (Figure 3, right chart).

In private equity, 24% of respondents have thus far made no allocations, 57% have allocations of up to 5% and 19% have allocations of over 5%.

In private debt, 34% have no allocations, 57% have allocations of up to 5% and 9% have allocations of over 5%.

There are two salient points behind these numbers. First, larger pension plans – on account of their superior governance structures and skill sets – tend to have much bigger allocations compared with their smaller peers. Amongst the largest allocators, the U.S. public sector plans predominate, partly on account of their regulatory status (Case Study 3). Second, geographically, the U.S. economy predominates, because of its less restrictive M&A rules on hostile takeovers, which facilitate high-volume buyouts in private and public markets alike. It reduces the appeal of public equity markets and delays the initial public offering of successful start-ups. As a result, global private equity company inventory has risen sevenfold in this century, creating scope for a good illiquidity premium.

In terms of meeting investor goals, the vintages of private equity and private debt funds raised in the aftermath of the 2008 Global Financial Crisis have delivered ESG outcomes broadly in line with expectations until the start of the bear market in 2022. They have also provided a diversification hedge in times of turbulence because they don't have to follow the mark-to-market accounting rules of public markets. Their valuations are anchored in capturing the idiosyncratic risks and returns of individual assets over longer horizons that deliver lower price volatility.

For its part, private debt has in-built safeguards that serve to protect against various downside risks. For example, its tightly written contracts lessen the 'J Screwed' risk – when a borrower moves assets to a subsidiary not bound by its credit agreements and then borrows more money against those assets. Furthermore, the bilateral relationship between a single borrower and a single lender tends to lead to renegotiation to avoid default if the borrower runs into difficulty, thus improving recovery rate. This is in marked contrast to when the debt is owned by multiple parties. Finally, private debt loans usually attract a floating rate, offering investors some protection against inflation-eroding returns, unlike fixed-rate bonds, which lose value when inflation or interest rates rise.

CASE STUDY 3 The search for uncorrelated absolute returns

A U.S. public sector pension plan

The dotcom crash in 2000-02 was a turning point. It showed that risk did not generate returns; nor did diversification work when it was most needed in the bear market. So, we embarked on a phased program of expanding our private market footprint, with an initial base of 8%, covering real estate and private equity. Over time, we ventured into infrastructure and private debt, resulting in our current allocation to 26%, of which private equity accounts for 12% and private debt 3%. Both hold special attraction for us beyond their ESG appeal.

They have served to bridge our funding gap by delivering good returns and reducing our liabilities under current public pension accounting standards.

This allows us to use the expected rate of returns on our investments as a discount rate in measuring our liabilities, thus serving to reduce them, since private markets deliver higher returns. Given the bespoke nature of their deals, these two private market assets have also lowered portfolio volatility, since they do not come under mark-to-market rules. Finally, private equity and private debt have enabled us to diversify into new business models in the ESG space that target stable sources of value creation in the world economy. Our allocations will rise once the U.S. economic outlook improves.

4. Private markets have their own downsides

“Higher interest rates can be a show stopper for private equity and private debt.”

An interview quote

As we saw in Section 3, pension plans’ allocations to private equity and private debt are still in the foothills of progress. A number of constraining factors have served to create a gradual advance. Some are related to pension plans and some to asset classes, as discussed separately below.

1. Constraints related to pension plans

The upper panel in Figure 4 sets out five key constraints. Topping the list is lack of governance structure and skillsets, as required by illiquid investments (62%). Only larger plans are known to have them and that is why they dominate the asset base in private equity and private debt (Case Study 4). The rest prefer to invest in asset classes that are tested by time and events. That aside, the improving funding ratios from rising interest rates are enticing plans towards an outright insurance buyout that disesteems illiquid assets (54%). Some plans have been exposed to the ‘denominator effect’ (49%): falling valuations in the 2022 bear market have hit public market equity valuations and artificially pushed the share of private market assets above its strategic target level. This has forced limited partners to reduce commitments or paused new private market investments altogether. Rising interest rates are also creating good fixed-income opportunities in public markets.

Two other constraints have also weighed on pension investors. One of them is the current political backlash against ESG investing in the U.S. (51%). The country holds around 65% of total global pension assets and a slightly higher share of global assets in private equity and private debt. Understandably, our U.S. survey participants remain very concerned.

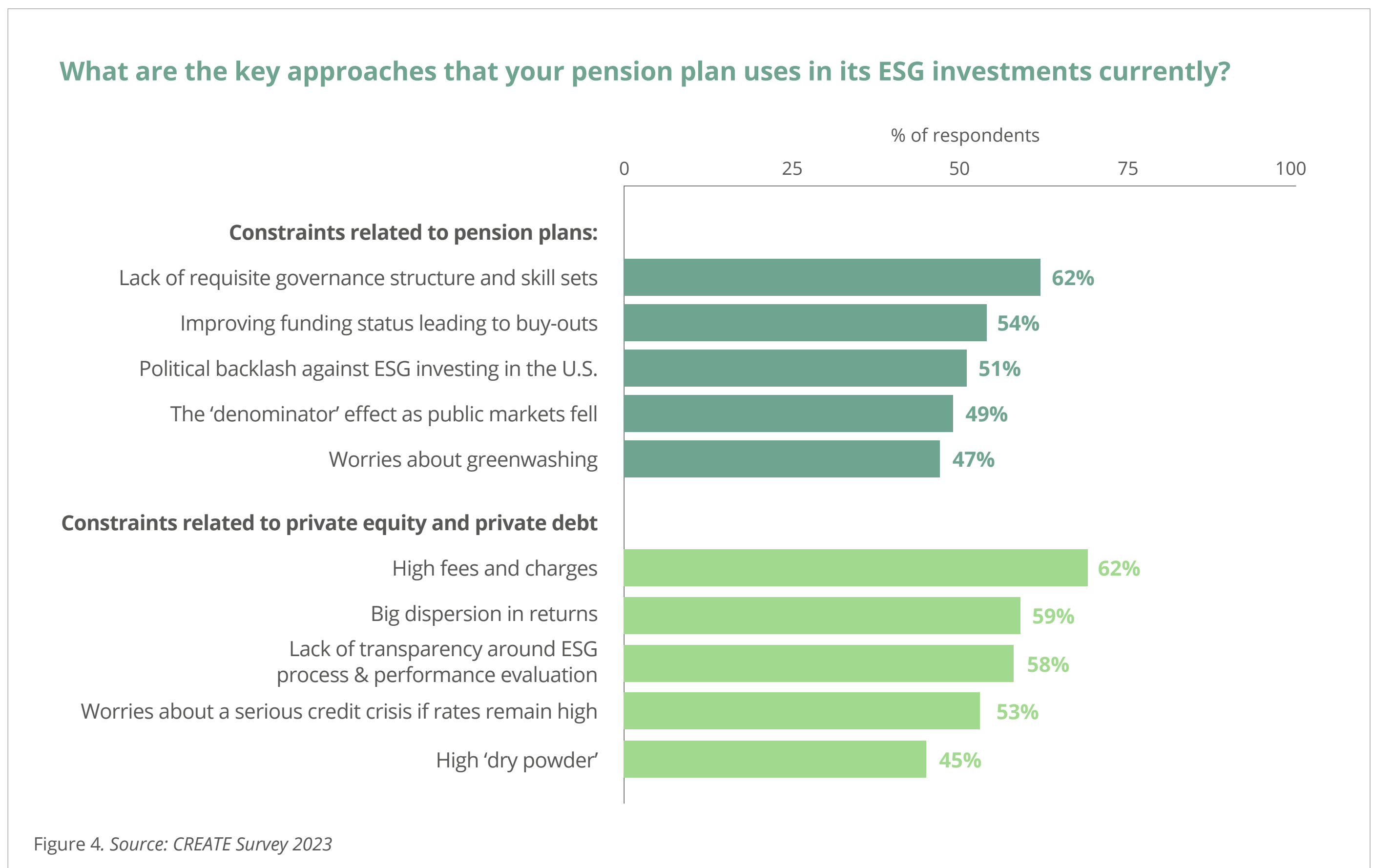


Figure 4. *Source: CREATE Survey 2023*

As investors are caught in the crossfire of rising political disputes, ESG investing has suddenly turned into a riskier proposition.

The final constraining factor focuses on greenwashing (47%): shortcuts taken by some asset managers to repurpose their old funds with an ESG label without rejigging the underlying investment process. Some prominent asset managers have been hauled over the coals in the media for such moral posturing.

2. Constraints related to private equity and private debt as asset classes

The lower panel in Figure 4 sets out the five key constraints. Topping the list is fees and charges (69%). The familiar 2-20 structure for assets locked in for extended periods is worrisome. Yes, private equity and private debt can add value relative to public equities, but a lot depends on the structure of the fund and the choice of manager. Their returns have high dispersion where the difference between the best managers and the rest is significant (59%).

These concerns are also magnified by a lack of transparency around ESG process and performance evaluation (58%). Lack of disclosure on portfolio companies and fellow investors remains a sticking point for pension plans. Because these investments have no easily observed market value, valuations of investments on an ongoing basis are more a matter of judgment than hard science. Apparently, investors have little idea of and no control over what is going into those funds and how they are actually invested.

Finally, forces that were tailwinds for private equity and private debt may well have come to an end, with steep interest rate hikes that started in 2021 in the key pension markets. There are worries about a serious credit crisis if high rates tip the global economy into a recession (53%).

Private equity groups enjoyed an extraordinary run of profitability in the past decade as low financing costs and buoyant financial markets made it easy to sell investments for gain. Now, the rising cost of capital could hit the deal flow as well as restrict exit options.

For private debt groups, it could also raise the default rate and expose risks that have been less visible in this new asset class. The European Union is now clamping down on the growing $1.5 trillion credit market with new rules to curb leverage and reduce risks to financial stability.

The prevalence of significant ‘dry powder’ in both asset classes is seen as a sign of a weakening opportunity set (45%). But, as we shall see in Section 5, it would be unwise to conclude that we have reached peak PE or PD.

CASE STUDY 4 Illiquidity premium is not suited to plans in the run-off phase

A Dutch pension plan

Our current total allocation to private markets is 15%, of which 4% are in private equity and 1% in private debt. About half of them are in ESG funds. In contrast, over 60% of our assets are now in public market bonds that mimic the cash flow profile of our liabilities. The reason is that we are cash flow negative: payouts to members exceed income from assets and contributions.

The positive mix of a big market rally in 2020–21 and rising rates has improved our funding ratio just as our liabilities are maturing and ever more plan members enter their golden years. We are now close to our End Game goal – insurance buyout.

This has meant going underweight in long-horizon illiquid assets that potentially offer inflation protection and illiquidity premium. But it is hard to exit them early without incurring a severe discount and high transaction costs. Besides, most insurers do not accept these assets in buyout transactions. They prefer liquid assets – like inflation-linked sovereign bonds – whose cash flow matches our liabilities. So, during the big dislocation in bond markets in 2021, we unlocked our equity gains and rotated into such bonds.

Another reason that our ESG allocations to illiquid assets will remain modest is that you need strong governance and skill sets to manage them. They require locking up capital for several years. Also, the capital allocated to a private fund is neither put to work immediately nor returned to the investor on a single future date. Managing cash calls and distributions need careful cash flow management.

5. The winds of change in private markets

"Growth dynamics remain positive but SEC reforms will likely dilute them."

An interview quote

Private equity and private debt have gone from strength to strength over the past five years, rising in popularity with pension plans globally. Private equity, in particular, raised over $2 trillion in the period 2019–22, rising to about $5 trillion with leverage, according to data from Pitchbook. The highwater mark was in 2021; growth will likely continue but at a more subdued pace. Two sets of drivers will fuel growth over the next three years: one will affect pension plans, the other will affect private equity and private debt as asset classes. But these may well also experience headwinds from new regulation in the U.S. and the European Union.

1. Drivers affecting pension plans

As the upper panel in Figure 5 shows, topping the list of drivers is the heightened search for good long-term risk-adjusted returns (61%). Public equity markets are likely to remain volatile while inflation and interest rates remain high. They may well be in a low real return era because central banks' easy money policies since 2008 have borrowed against future returns in what was the longest bull phase in history, disconnecting markets from the real economy. Besides, the continuing de-equitization has been eroding opportunity sets in public equities (57%).

For their part, regulators in jurisdictions as diverse as the EU, Hong Kong, Singapore, and the UK are relaxing liquidity rules for defined contribution pension plans where daily liquidity needs have long unduly eroded returns (52%). Regulators in the UK are the latest to express the desire to harness pent-up interest in private equity and venture capital (Case study 5). This is happening against the

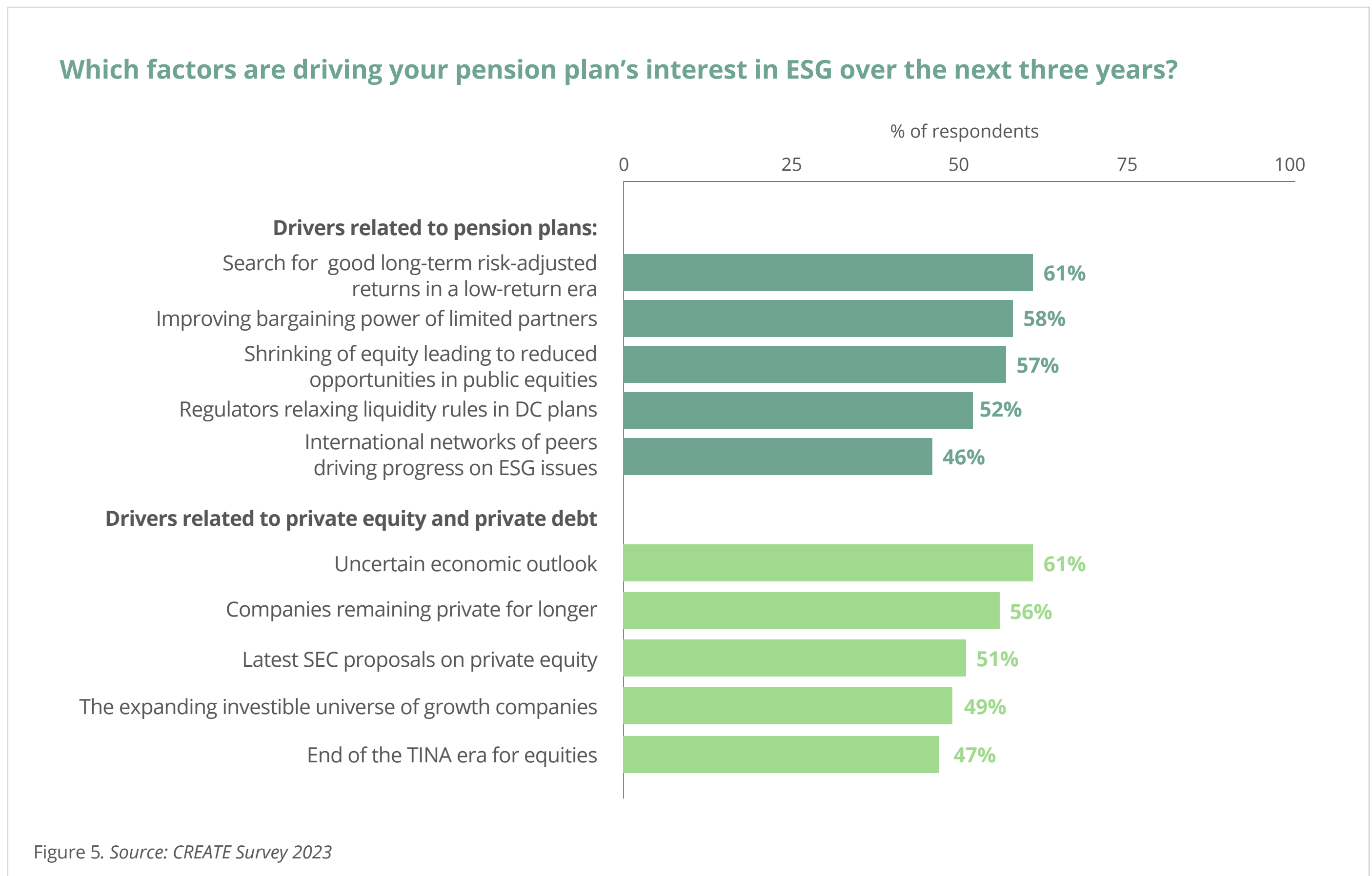


Figure 5. *Source: CREATE Survey 2023*

backdrop of two other developments. The first is the improving bargaining power of limited partners, as rising interest rates have hugely jacked up the cost of leverage in private equity and private debt deals (58%). The second is the rising influence of international networks of asset allocators who are driving progress on ESG issues (46%). Climate Action 100+ has recently upped its scrutiny of carbon offsets and capex spending on climate action via a new set of disclosure indicators.

2. Drivers affecting private equity and private debt

The drivers shown in the lower panel in Figure 5 have variable impacts: some power further advance, others act as a drag on it.

Taking them in turn, companies are likely to remain private for extended periods (56%). This is because the IPO process in key markets is seen as cumbersome and the bureaucracy of public markets as onerous; just when growth capital can be readily accessed in private markets. On the flipside, this means there is a paucity of pure-play impact companies in public markets, making private markets more attractive for impact investing. Thus, the era of TINA to equities may soon be over (47%).

In the pension landscape, there have been growing concerns that what has long passed as active equity investing in public exchanges is simply the second-order trading of existing paper assets that have little to do with value creation. This is further reflected in the expanding investible universe of dynamic companies in private markets (49%).

That brings us to the two forces that are likely to be a drag on future growth. One is the uncertain economic outlook (61%). The question uppermost in the minds of our survey respondents is whether, after sharp hikes in interest rates, the US Federal Reserve can now engineer a safe landing that reduces inflation risk and recession risk. Recession could undermine exit strategies in private equity and debt servicing ability in private debt.

The other significant unknown is how the SEC's latest raft of sweeping reforms will impact the private equity industry (51%). The reforms require detailed quarterly reporting on fund performance, prohibit side deals that give better terms to some investors and put limits on the expenses that can be passed on to clients. The proposed rules will not only affect asset managers based in the U.S. but also foreign ones who take money from U.S. investors. Potentially, the reforms may well amount to the SEC dictating which terms are and are not permissible in fund mandates.

On current reckoning, therefore, the U.S. is expected to remain the powerhouse of private equity and public debt investments, but growth is more likely in Europe and Asia-Pacific.

CASE STUDY 5 The wane of the 'cost is king' culture

A UK pension plan

The UK's workplace defined contribution system is set for a big shake-up after decades of over-emphasis on costs to the detriment of returns. Like its peers in Australia and Canada, it is now permitted to invest in high return potential assets like private equity.

The UK's Long-Term Asset Fund came into force in 2021. It relaxed the 0.75% charge cap imposed on DC default funds, making it easier to include performance fees typically imposed by managers of illiquid strategies. That was followed this year by a ringing declaration from the government that unlisted companies are vital to the UK's economic growth, leading to an undertaking by some of the biggest pension managers to allocate 5% of their funds to private equity and early-stage firms. In addition, the UK government has begun consultation on doubling existing local government pension plans' allocations to private equity to 10% by 2030.

Regulators are to be given fresh powers to close down underperforming pension plans in a bid to create larger plans with more stable cash flows to make meaningful allocations to illiquid assets. Just as decisive is the shift from costs to performance when assessing value for money. The expectation is that private equity managers will be prepared to cut fees in return for a regular capital stream from the larger schemes.

6. Manager selection is key

"The implosions of crypto exchange, FTX, and Silicon Valley Bank show that all that glitters is not gold."

An interview quote

History may well record the last decade as a golden age for investors. The ultra-accommodative monetary policies of central banks staved off a 1929-style depression following the global financial crisis in 2008 sparked by the Lehman collapse. As a side effect, they boosted public market asset valuations by effectively putting a floor beneath them and dampening volatility.

Similarly, zero-bound interest rates shrunk the cost of capital and put a rocket under private market asset prices. The ensuing prolonged period of relative calm arguably lulled investors into undervaluing the importance of the due diligence process when selecting external asset managers.

This is now no longer the case, thanks to central banks' hawkish rate hike blitz to regain credibility after losing control over inflation in 2021.

Pension plans have become increasingly concerned about the scale of greenwashing in their ESG funds, as implied by the 2022 report from the non-profit US Sustainable Investment Forum ("SIF"). Using a refined methodology, it nearly halved the size of the U.S. sustainable investment universe to $8.4 trillion in 2022, compared with $17.1 trillion in 2020. A similar downgrade happened in the EU after the Sustainable Finance Disclosures Regulation ("SFDR") regime beefed up its disclosure rules.

Thus, when selecting managers in private equity and private debt for ESG investments, the top five criteria fall into two sets.

1. Baseline criteria

These apply to the basics of private equity and private debt and cover three items (Figure 6, upper panel). Here, fees and charges top the list (63%). There is a perception that, at least for the foreseeable future, investors will have to lower their return expectations, as leverage will be far more costly under the new monetary regime of high rates. These work with a variable time lag of 12–18 months. As they hit the real economy, the default rate is set to rise. Investors want their managers to deliver value for money within a win–win fee structure (Case study 6).

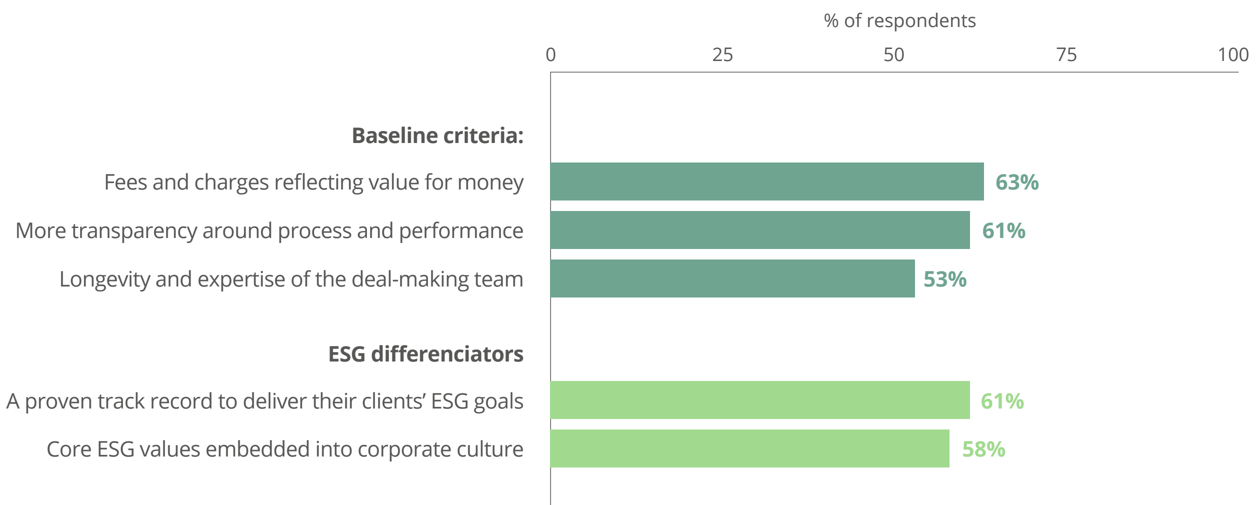


Figure 6. *Source: CREATE Survey 2023*

Additionally, they want to see much greater transparency of business processes – including deal origination, risk management, and performance measurement – backed by quarterly reporting (61%).

Finally, there is heavy focus on the longevity of the deal team to ensure that there is stability of staff across the whole value chain during the duration of the deal (53%). An experienced talent pool is seen as the lifeblood of the business as it transforms portfolio companies from laggards to leaders. In this context, the biggest houses are seen as having the most experienced teams, which has reportedly raised their share of deal flows dramatically over the past ten years: from 60% to 90%.

2. ESG differentiators

To win an ESG mandate, baseline criteria are necessary but, by themselves, insufficient. A proven track record – embodying the materiality, intentionality, and additionality principles – that delivers clients' ESG goals is essential (61%). Across Europe, ESG goals have become part of pension plans' fiduciary responsibility under regulations such as the EU's Corporate Sustainable Reporting Directive 2022, and the 2022 Climate and Investing Reporting in the UK.

To ensure that this proven track record can be replicated in future, pension investors also want to ensure that ESG values are embedded in the corporate DNA of their asset managers (58%). That means business leaders at asset managers have to set the tone at the top by:

- fostering the belief that ESG is not just a fad but a sea change in the art of investing;
- ensuring joined-up thinking between the investment team and the stewardship team;
- linking the compensation of the executive team and staff to well-defined ESG goals;
- encouraging regular engagement with investee companies, setting realistic goals, and monitoring progress using robust outcome metrics;
- focusing engagement on narrative disclosure – the real-life stories of challenges, actions, and outcomes that lie behind the dry numbers on ESG progress.

The aim here is to create businesses of enduring value for four stakeholder groups: shareholders, employees, customers, and wider society.

CASE STUDY 6 Rise of the hybrid approach

A German pension plan

During the era of negative interest rates in the Eurozone in the last decade, our portfolio first pivoted towards private markets, with a 2% allocation to private equity and 1% to private debt – in both cases to the senior part of capital structure of the funds in question. Whilst such funds have a proven track record on ESG matters, we only use them within bigger open-ended funds that capture illiquidity premium. At the same time, we manage liquidity constraints by including liquid public market assets as a rebalancing device that protects the existing locked positions on private assets.

So far, this approach has worked well for us in terms of delivering a triple bottom line. But before we raise our allocations, our asset managers need to make progress in the three key areas that matter to us most.

The first is fees and charges. As the balance of power has shifted from general partners to limited partners in an increasingly competitive market, the 2-20 fee structure is untenable in an environment where fixed income returns in liquid markets are attractive and where the cost of leverage in private markets has shot up to the point where juicy returns may well be history.

Greater transparency is another area where further progress is vital. If private equity investments are so great, why are the details so sparse? We need far more information on investment process, risk controls, and performance measurement. It is also vital for us to know who our fellow investors are.

Finally, we shall select only those asset managers with very low corporate defaults and a sound track record of loss recovery. That means having 'cradle to grave' teams where key members are around throughout the life cycle of the deal.

7. Conclusion

One of the legacies of the 2022 bear market is that it has started a decisive shift in the ESG investing of pension plans: from quantity to quality. Pension plans want to be assured that their investments are geared towards delivering a triple bottom line: decent financial returns on top of a planet that is fit for habitation and a society in which no one gets left behind.

Their allocations to private equity and private debt are set to rise, as they intensify their search for decent returns in a low nominal return environment. They see dynamic growth companies remaining private for longer and delivering decent illiquidity premia.

However, with interest rates expected to remain higher for longer, pension plans worry that the rising cost of capital could hit the deal flow as well as restrict exit options, bringing to an end an extraordinary era of profitability that benefited from central banks' cheap money policies. Moreover, a significant level of 'dry powder' in both asset classes is seen as heralding narrowing opportunity sets.

In this restrictive environment, two concerns need to be addressed if allocations to private equity and private debt are to rise.

One is the fee structure: locking in assets within the traditional 2-20 format over extended periods remains an obstacle, all the more so since returns remain a high dispersion space. The difference between the best managers and the rest is striking. A lot depends upon getting manager selection right. Fee models that deliver value for money would attract higher allocations than ones based on a fixed formula.

Another concern that needs to be addressed is the seeming lack of transparency around the ESG process and performance evaluation. Pension plans want to have much greater transparency across the value chain of investing particularly around risk models, the type of companies in the portfolios, and the identity of fellow investors.

The intrinsic alignment between ESG factors and private equity and private debt remains as strong as ever. By addressing these two concerns, general partners can widen and deepen the ESG footprint of their investment portfolios by attracting more pension assets.

Acknowledgements

Pension plans worldwide are advancing into private markets in search of absolute uncorrelated returns. An increasing number of their mandates now incorporate ESG factors.

This report highlights the experience of pension plans investing in two fast-growing asset classes: private equity and private debt, which are integrating ESG considerations across their investment cycles. It aims to highlight the key trends, the challenges they give rise to, and the actions they require from the managers of these two asset classes, as they aim to attract ever higher allocations.

The losses in ESG investing sustained in public markets in the 2022 bear phase has forced introspection among pension plans. The survey provides a timely perspective on how that will affect their allocations to private market assets.

My thanks go to the 152 pension plans across Asia-Pacific, Europe, and North America that participated in our survey. Their practical insights shed light on how ESG-informed investing is playing out on the ground in key pension markets.

I would also like to thank Apex Group for sponsoring the publication of this report. Their support has helped to elicit a wide spectrum of views in the pension community, enabling a representative assessment of current trends and future evolution.

Finally, I would like to thank four colleagues at CREATE-Research: Lisa Terrett for managing the survey, Anna Godden for assisting with the literature search, Naz Rajan for data analysis, and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors or omissions in the report, I am solely responsible.

Amin Rajan
Project Leader, CREATE

apexgroup.com

Contact us | Disclaimer

create-research.co.uk

This content is for general information purposes only and is not intended to constitute legal or other professional advice, and should not be relied on or treated as a substitute for specific advice relevant to particular circumstances.

© 2023 APEX GROUP ALL RIGHTS RESERVED