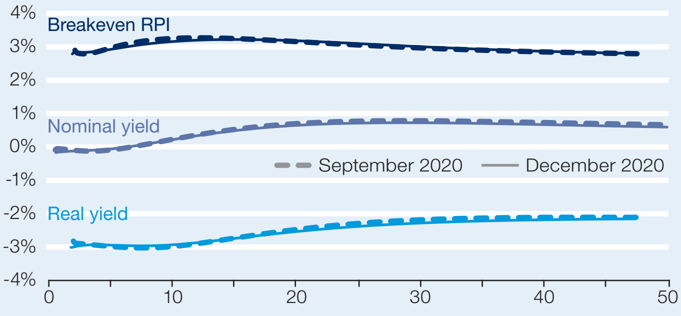
Market Monitor: Q4 2020

Alpha Real Capital

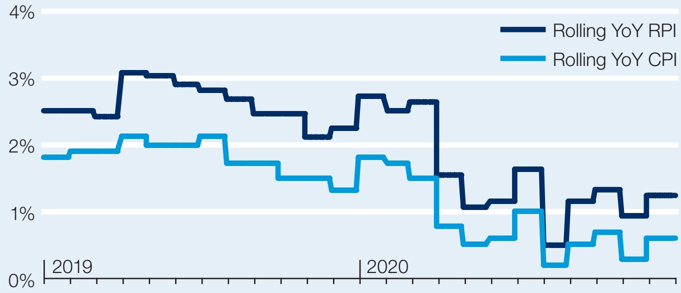
Rates, inflation and credit spreads

Gilt yield curves



Source: Barcap – 30 September 2020 and 31 December 2020

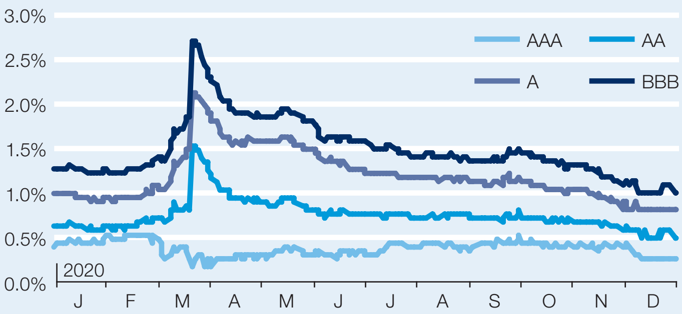
12 month rolling inflation



Source: ONS - 31 December 2020

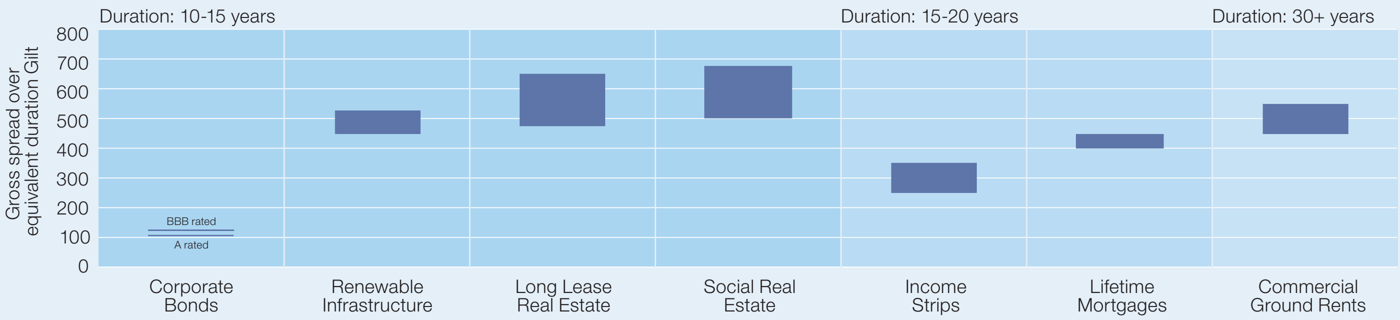
- Real Gilt yields have increased over the quarter at the shorter end of the curve and fallen over the medium and long term. This is primarily driven by the decrease of short-term inflation expectations and a minor increase in the medium and long-term.
- Whilst inflation started to rise in October, due to the recent Covid restrictions implemented, it has returned to similar levels as the start of the period.
- Investment Grade bonds have continued to benefit from a "flight to quality"; credit spreads for UK Investment Grade bonds remain tighter than pre-Covid levels.

Credit spreads



Source: S&P Capital IQ 10 year non-financial GBP bonds, Z-spread – 31 December 2020

Secure income market update



Spreads remain compelling for secured long income assets

- As the Covid-19 period lasts, resilience continues to be demonstrated across Long Lease real estate markets, most notably for high quality Income Strips, Social Real Estate and Commercial Ground Rents.
- Spreads over Gilts for these illiquid asset classes have remained relatively constant because of the limited movement in Gilt yields over the quarter and the pricing stability of Secure Income assets.
- Yields available for Renewables Infrastructure and Lifetime Mortgages continue to remain broadly unchanged.

Asset class definitions

Renewables Infrastructure: 15+ year inflation-linked cashflows from unlevered wind and solar infrastructure assets subject to Feed-in Tariff (FIT) or Renewable Obligation Certificate (ROC) regimes.

Long Leases: 15+ year inflation-linked leases on commercial real estate. Traditional sale & leasebacks fall within this market.

Social Real Estate: 15+ year inflation-linked leases on real estate assets that accommodate or facilitate social activities or services.

Income Strips: 30+ year inflation-linked leases on commercial real estate where the lessee has an option to purchase the real estate back at the end of the lease for a nominal amount (e.g. £1).

Commercial Ground Rents: 100+ year inflation-linked leases on commercial real estate, with a higher degree of rental and value cover than a traditional sale & leaseback.

Lifetime Mortgages: portfolio of loans from individual borrowers aged 55+ seeking to release equity from their property; the coupon rolls up (rather than cash-pay) and the mortgage is repayable on death or when entering long-term care.

Sources: Alpha Real Capital (for illustrative purposes only and for typical transactions available to pension schemes in these asset classes). Data as at 31 December 2020. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature. Source of corporate bond spreads: S&P Capital IQ 10 year non-financial bonds – 31 December 2020.

Expected level of returns from secure income assets in line with equities: Which opportunities can pension schemes take advantage of today?

Pension schemes' challenge

With pension schemes maturing[1] and becoming cashflow negative[2] there is an increased focus on being able to generate predictable cashflows to meet liabilities. At the same time, as most schemes remain underfunded[3] there is also a need to generate further investment returns to help close funding gaps.

This dynamic explains the increasing demand for secure income assets, such as private or illiquid assets that could generate predictable cashflows to help match liabilities, whilst also delivering investment returns to help close deficits.

Competition for secure income assets

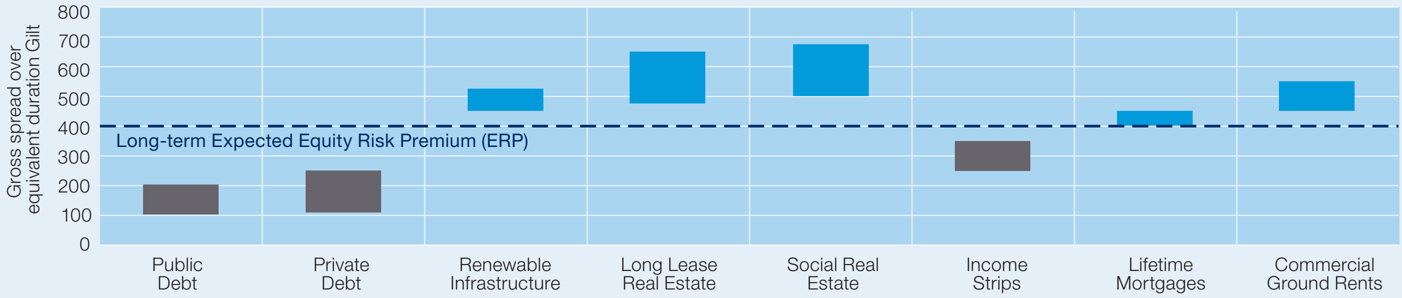
The supply of secure income assets is however limited, and competition for them is commensurately high. Pension schemes must compete both against each other, and with insurers who are long-established and significant investors in some of these assets.

Pension schemes nevertheless benefit from not being constrained by the same stringent investment restrictions as the insurers. Simply put, they do not need to chase the same 'overbid' assets that insurers are competing for.

De-risking without impacting returns: which secure income assets could generate returns in line with the expected level of return on equities?

Logically, if the secure income assets purchased have similar expected returns to the assets being sold, then the overall expected return on the scheme's assets could be maintained whilst in this case concurrently also reducing risk.

Recent conversations with institutional clients and their advisors suggest an expected assumption for long term Equity Risk Premium[4] ("ERP") in the region of 4% p.a. Some advisors have even proposed that ERP could actually be reduced by 0.5% p.a. given the recent high equity returns. Accordingly, in order to maintain expected returns when de-risking out of equities the secure income assets need to generate comparable yield pick-up over Gilts.



The diagram above shows the typical gross spreads available relative to Gilts on some of the main types of secure income assets[5]. The spreads for public debt (e.g. investment grade quality buy-and-maintain corporate bonds) and a typical assumption for the ERP are included for comparison.

- The secure income assets that could generate returns in line, or even above the expected level of equities or even above (whilst generating predictable and secure cashflows) lie above the ERP line and are highlighted in light blue.
- The assets that insurers typically invest in, highlighted in grey in the chart above, command the lowest spreads over Gilts.

1 88% of DB pension schemes are closed in the UK (Source: The Purple Book 2019, PPF)

2 66% of DB pension schemes are already cashflow negative and more than half (53%) of cashflow positive plans expect to become cash flow negative within five years (Source: Mercer European Insights Report 2020).

3 89% of DB pension schemes remain underfunded on a full buy-out basis (Source: The Purple Book 2019, PPF).

4 The Equity Risk Premium (ERP) – an excess (long term) return that investing in equities could generate over a risk-free rate (e.g. UK government bonds). ERP could vary with the composition of the equity portfolio and/or the time horizon chosen. It could also change over time as market conditions changes.

5 Public Debt – investment grade quality buy-and-maintain corporate bonds, Private Debt – infrastructure debt and real estate financing, Other assets classes – see definitions on the front page.

Source: Alpha Real Capital, indicative levels as at 31 December 2020. For illustration purposes only. The future returns and opinions expressed are based on Alpha Real Capital internal forecasts and should not be relied upon as indicating any guarantee of return from an investment managed by Alpha Real Capital nor as advice of any nature.

Contact Alpha Real Capital

Please get in touch with your usual Alpha Real Capital representative or contact:

Hattie Walton

+44 (0)207 391 4568

hwalton@alpharealcapital.com

Alpha Real Capital

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