# Outlook 2022

What are the key themes that will weigh on investors' minds and what is the outlook for secure income real assets?

Alpha Real Capital

# As we embark upon 2022, what are the key themes that will weigh on investors' minds and what is the outlook for secure income real assets?

We see strong demand for secure income real assets continuing in 2022 and beyond. This is because secure income real assets are long-dated, inflation-linked, and income generating by nature. They also dampen portfolio volatility and offer diversified sources of return. These characteristics will help investors navigate the risks they currently face – chief amongst these being the risk of higher inflation.

In addition, there are well established longer-term features of the market that will influence investor decision making:

- Pension funds continue to de-risk their portfolios and may need to increase their inflation matching assets. Demand for long dated and inflation-linked assets that provide high quality income is likely to continue to outstrip supply.
- ESG is firmly on the agenda for 2022 and beyond. Alongside taking steps to deliver on net-zero pledges and meeting new reporting requirements, investors are increasingly looking to focus on the 'S' in ESG.
- Investors are increasingly moving into private market assets in search of yield, wider opportunities and portfolio diversification. This trend means that there will be a natural flow into real assets, especially given investor appetite to match liabilities while earning higher returns.

We explore these themes to present the role secure income real assets can play in investor portfolios.

## So what risks do we see in the short term?

A key question on investors' minds is whether high inflation will persist? Perhaps more importantly in the shorter-term, there may be concern over the risk that policy errors will be committed as central banks embark on monetary tightening. Tighten too early or too fast and economic growth is damaged (accelerating the economic cycle and causing asset market volatility). Tightening too slow and/or too late may mean inflationary forces become unmanageable.

If this balancing act was not difficult enough, Omicron showed that the virus is still with us and it could derail a resurgent world economy. The virus is unpredictable. There are also geo-political risks (Russia and Ukraine, China and Taiwan) and heightened political risk in the UK, US, and Europe.

In short, we anticipate increased volatility in equities and other assets in 2022. In these circumstances, investors are likely to desire greater stability in their portfolios.

## Pension funds – primed to de-risk

Fortunately, many investors will have benefited from the good performance of risk assets in 2021. Taking pension funds as a relevant example, the chart below shows how a typical pension fund performed from just before the pandemic through to the end of 2021. Most pension schemes have made good progress towards reaching their end-game.

### XYZ Pension Scheme – funding level


Source: Alpha Real Capital modelling. Liabilities: 18 year duration, 70% inflation linked. Allocation: 30% Equities, 25% sterling corporate bonds, 10% distributed equally to Property, High Yield Debt, Emerging Market Debt, 35% LDI (achieving 70% inflation and interest rate hedge).

### End-games

**According to recent research commissioned by ARC, just over 90% of schemes have 'developed' or 'very developed' long-term funding objectives. Schemes are targeting buy-out, and low-dependency. Notably they are also targeting consolidation vehicles. This latter option became more realistic from November 2021 as the first so-called 'pension superfund' was authorized to conduct business, although the market awaits its first transaction. Only 2% of schemes surveyed said they were undecided on their long-term objective.**

From these findings we conclude that many pension schemes are primed to de-risk their portfolios further, and importantly they can afford to do so. With potential market volatility in 2022, many schemes are likely to be looking for ways to lock-in the gains made through the pandemic period and to reposition their portfolios for a more certain path to their end-game portfolio.

## Inflation risk and real assets

According to our research, pension scheme inflation risks are generally well hedged. Using Liability Driven Investments (LDI), the typical pension scheme has hedged 70% to 80% of their inflation risk, which suggests that the current heightened inflation risk environment is something that scheme trustees do not need to lose much sleep over. However, that is not necessarily the case.

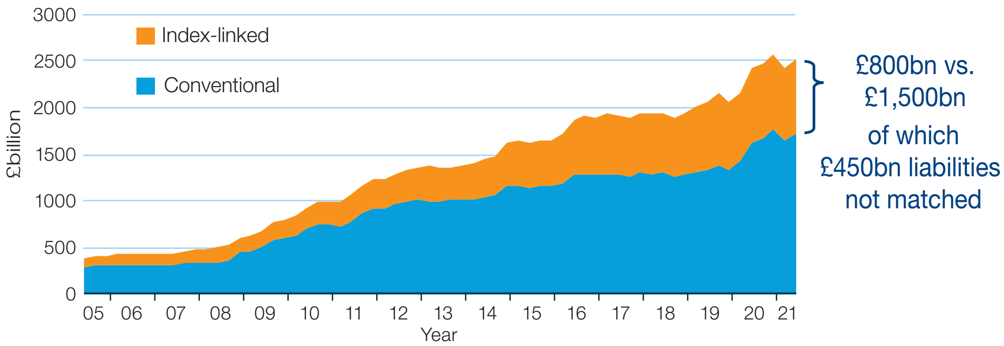
### There is a shortage of inflation-linked assets

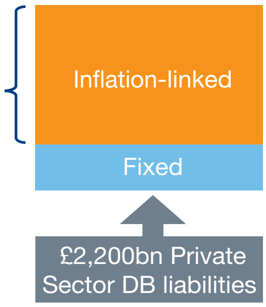
The first order problem is a lack of supply of inflation matching assets. There simply are not enough long-dated inflation-linked assets to meet investor appetite.

Schemes are getting closer to their end-game and need to bear down on inflation and interest rate risk. Whether the target is insurance buy-out, a low dependency run-off portfolio or going into a consolidation vehicle, all of these end destinations for pension scheme liabilities involve even higher inflation hedging levels than currently prevail. Investors backing these liabilities will therefore be faced with the challenging task of finding suitable matching assets.

In a recent paper 'Will inflation take off' we estimated that the unmatched inflation-linked liabilities from UK defined benefit pension schemes indicated a shortfall of £450bn of index-linked gilts.

**Market value of gilts and index-linked gilts**




Source: Office for National Statistics, Pension Protection Fund, Alpha Real Capital calculations

**Rounding for simplicity, total UK DB pension fund liabilities come in at around £2,200bn*, of which c.£1,500bn are inflation linked. Given there are only £800bn of index-linked gilts, straightforward arithmetic indicates there is a shortfall of £700bn. However as many schemes use LDI techniques, the portion of inflation-linked liabilities that are matched is actually higher at around 70% – or £1,050bn. That still leaves 30% or c.£450bn of un-hedged inflation linked liabilities.**

* For those interested – we have estimated the pension fund liabilities as the value of full buy-out liabilities using Pension Protection Fund figures (Purple Book 2020 and August PPF 7800 Index). We have assumed 2/3rds of liabilities are inflation-linked.

The demand for long dated assets is high, as illustrated by:

- On 23 November 2021, £1.1bn of index-linked gilt 2073 (nominal) was issued. The demand for this was £17.7bn (nominal) which means it was 16x oversubscribed. The sale cleared at a yield of -2.38%, a record low yield for a syndication. The 2073 is now the longest dated index-linked gilt, and the November syndication was the first extension of maturity since the 2063 was issued in 2013.
- The recent rise in yields has been pronounced at shorter maturities; however, longer-term and real yields are still below pre-pandemic levels, as shown in the table below which compares gilt market rates over last three Januarys (2020, 2021 and 2022).

| | Nominal yields | | Real yields | | Inflation | |
|---|---|---|---|---|---|---|
| Maturity | 10 | 30 | 10 | 30 | 10 | 30 |
| January 2020 (% p.a.) | 0.79 | 1.3 | -2.44 | -1.85 | 3.23 | 3.15 |
| January 2021 (% p.a.) | 0.23 | 0.78 | -2.98 | -2.27 | 3.21 | 3.05 |
| January 2022 (% p.a.) | 1.08 | 1.21 | -2.87 | -2.25 | 3.95 | 3.46 |
| Difference: Jan 2020 to Jan 2022 | 0.29 | -0.09 | -0.43 | -0.4 | 0.72 | 0.31 |

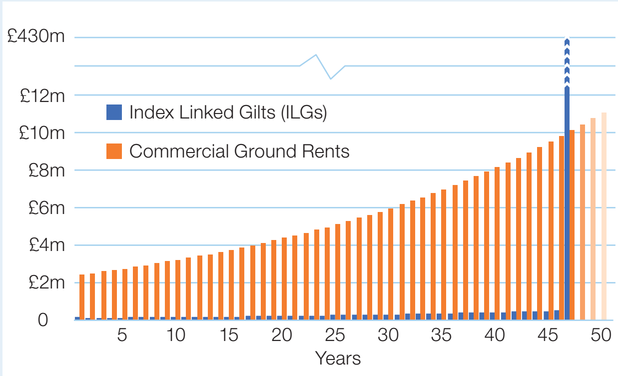
Source: Bank of England

## Private markets mean supply can be customised to investor needs

**Given the scarcity of inflation-linked assets, secure income real assets are a welcome source of supply. The private markets nature of these assets is also an opportunity for investors to structure assets to better suit investor requirements. Commercial Ground Rents (CGRs) are a good example of what can be achieved. Versus just holding index-linked gilts (ILGs):**

- CGRs provide a good risk-adjusted return. They currently trade at spreads of c.4% to 5% over long-dated index-linked gilts for which the investor receives investment grade cashflows, income security, inflation-linkage and capital stability.
- The cashflow profile is also more attractive than for ILGs (see chart below).
  - The income generated is significantly higher for CGRs, whereas for ILGs the income is very much back-end loaded. That is due to the inflation-linked principal repaid at maturity.
  - The higher income level from a secure asset gives more investment freedom to the pension scheme to pursue opportunities and avoid having to sell assets to meet pension payments (for example).

### Portfolio cashflows: Commercial Ground Rents vs. Long dated Index Linked Gilts (£100m invested)




Source: Alpha Real Capital, for illustrative purposes only.

- A more accurate matching asset for inflation linked liabilities. The inflation-linkage in CGR contracts is linked to RPI with caps and floors as opposed to just RPI. Such 'limited price indexation' will be familiar to pension schemes as their pension payments also feature caps and floors. This means the inflation in the asset accurately matches that of the liabilities (see '[Q4 2021 Market Outlook](#)').

## ESG and real assets

Pension scheme ESG requirements are rapidly evolving and secure income real assets provide great opportunities to invest directly into assets with positive ESG characteristics.

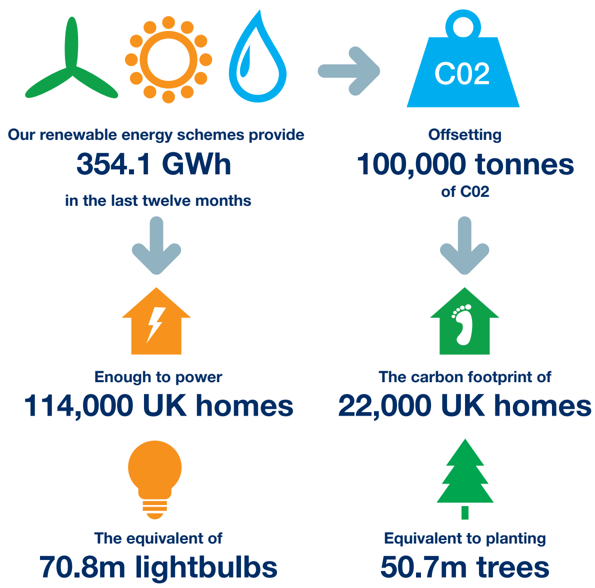
### Environmental

The main area of focus for investors when it comes to ESG remains the environment, and climate change in particular. On this front, many pension schemes have joined other institutions and stakeholders in pledging to be net-zero investors within a defined time-frame (usually by some time before 2050).

Going forward the focus will naturally shift to implementing paths to and measuring progress towards net-zero. A key requirement in this regard is engagement with investee entities, which is needed to gather climate related information and to influence changes in behaviour. While much progress is being made it is safe to say that industry standards are not yet developed and quantifying progress to net-zero remains a challenge. In any case, the built environment and the path to net-zero are very much linked and owners of real assets will be well placed to make impactful investments.

One specific asset class that directly contributes to net-zero ambitions is renewable infrastructure. At ARC we have seen considerable interest and our renewables portfolio of mainly on-shore wind farms is now close to £800m.

### Portfolio environmental benefits




Source: Alpha Real Capital, for illustrative purposes only.

While traditional opportunities in renewable infrastructure provide contractual inflation-linked income there are also opportunities to invest in emerging areas such as battery and energy storage technologies. We see a clear trend towards a diversified approach to investing in renewables.

## Social

**A recent survey commissioned by ARC revealed that over the next two years, 58% of UK pension schemes interviewed who collectively manage around £143.6 billion, believe institutional investors will increase their allocation to real estate investment vehicles offering a social benefit. Just 5% expect allocation levels to fall.**

A growing number of investors are now also focusing on the ‘S’ in ESG. They are looking to make a social impact as well as ensuring they are investing in assets that provide a sound financial return. A compelling way of doing so is by investing in Social Infrastructure, also known as Social Real Estate. This comprises physical assets across a range of sectors, which accommodate or facilitate social activities or services, delivering positive outcomes for the people and communities that those assets serve. Broadly, they fit into the groupings of housing, healthcare and education. These broad groupings include a variety of asset types, such as:

| Housing | Healthcare | Education |
|---|---|---|
| • Senior living / retirement<br>• Extra care<br>• Affordable housing including key worker<br>• Student<br>• Homelessness<br>• Specialised supported | • Care homes<br>• Specialist care homes<br>• Primary care<br>• Secondary care<br>• Private treatment / specialist clinics | • Day nurseries<br>• Primary, secondary and Special Educational Needs and Disability facilities<br>• College or university faculties |

Source: Alpha Real Capital

A distinctive feature of Social Infrastructure is that demand is driven by demographic shifts in society – it is structural and long-term in nature, as opposed to being cyclical and economically influenced (as in say, the retail sector). One well-observed demographic shift is the UK’s growing and ageing population which is expected to increase demand for public services. In addition, as these services tend to be essential (reflecting their infrastructure-like characteristics), the demand is underpinned by public sector funding. Such funding certainty was evident during the Covid-19 pandemic, as it ensured tenants were able to continue to pay rents in full and on time across Alpha’s Social Long Income Fund.

### Social Infrastructure offers investors:

- **Favourable market dynamics:** a ‘perfect storm’ of structural demographic demand, coupled with inefficient and insufficient stock, underpins an urgent need for capital investment. With public finances stretched, private capital will be needed to support the delivery of assets across housing, healthcare and education sectors – an opportunity that could be over £50 billion. See ‘Social Real Estate: A £50bn secure income opportunity?’.
- **Tangible ESG benefits:** as well as delivering on Environmental aspirations through the development and acquisition of modern, operationally and energy efficient assets, investments in Social Infrastructure can deliver quantifiable societal benefits, satisfying investors’ Social targets as part of ESG and SRI strategies – a diversified portfolio could deliver £5 of social value for every £1 invested.
- **Very compelling investment outcomes:** a multi-sector Social Infrastructure strategy could deliver high-quality, long duration, inflation-linked cashflows at spreads of 5%+ p.a. over comparable index-linked gilts.

Social Infrastructure is therefore a unique opportunity for investors to make a tangible difference to society while also achieving a compelling risk-adjusted financial return...

It also fits in well with investors (such as Local Government Pension Schemes) that want to make a difference in their communities by helping to meet local needs for updated and expanded social real assets. A local approach can be combined with a national approach to build a diversified portfolio of Social Infrastructure assets – an approach implemented for one of our clients is described in ‘Social Real Estate: delivering local and national impact’.

## Private markets and real assets

Investors are increasingly moving into private market assets in search of yield, wider opportunities, and portfolio diversification. This ongoing trend means that there will be a natural flow into real assets, especially given investor appetite to match liabilities while earning higher returns.

### Attractive return expectations

The chart below illustrates the attractive spreads currently available in a number of secure income real asset classes.

**Secure income spreads above UK government bonds – End December 2021**


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 2021. 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 2021.

With government bond yields and public market corporate bond spreads close to historic lows, the additional spreads currently available are attractive. For example, we can see that BBB rated public market bond spreads are below 1%, demonstrating the significant spread premium available from secure income assets.

In addition, at these spread levels relatively small allocations can have a meaningful impact. For example, many pension schemes are looking to eventually de-risk to portfolios targeting gilts + 0.25% to 0.5%. With spreads at 5%, it only takes a 5% portfolio allocation to secure income to achieve an expected return within this range.

### Demand for the illiquidity premium continues

The additional return expected from private market assets (versus similar public market assets) is generally referred to as the 'illiquidity premium'. This is a catch all term that reflects the higher costs, risks and complications of buying, selling and holding these assets.

While the illiquid nature of the assets may not be suitable for schemes looking to buy-out in the very short-term, a recently commissioned Alpha Real Capital Survey revealed that pension schemes are already harvesting the illiquidity premium.

- Around 58% of investors say their scheme allocates up to 25% to illiquid assets as part of their investment strategy.
- Nearly two out of five (37%) say they allocate up to 10% of their portfolio to illiquid assets, and 3% allocate more than 25%. Just 2% say they have no specific allocation to illiquid assets.

Furthermore, 85% of UK professional pension fund investors say the scheme they work for will increase its allocation to illiquid assets over the next three years, with 7% expecting a significant rise.

Another source of increasing demand is defined contribution (DC) pension schemes, with many DC investors now looking actively to include the illiquidity premium in their asset mix.

### Real assets and the 'G' in ESG

**If we look at UK DB pension fund asset allocations*, equities now comprise only 15% while the largest allocation is to bonds at 57% (mostly government and corporate bonds), with alternatives the next major component at 25%. Our survey also revealed that these allocations are substantially achieved using private market assets.**

**From a governance and stewardship perspective it is apparent that engaging with investee companies as bond holders and as private market investors is important. However, the template for engaging with investee companies is not as advanced as it is for public equity investments. Given the varied modes of ownership structures in private markets, more tailored and nuanced approaches are developing. However, one feature of private markets investing is a naturally closer relationship with investee companies, which is a good basis for meaningful engagement.**

* According to the Mercer European Asset Allocation Insights 2021

## Conclusion

As discussed in this paper, in addition to attractive returns, secure income real assets offer a number of other benefits.

- Their use expands the supply of assets that match pension scheme liabilities. After all, pension scheme liabilities are contractual in nature and matching these with contractual cashflows that are similar in nature (term and inflation-linkage) increases certainty, which is particularly useful given the uncertain outlook in the short-term.
- Real assets provide some unique opportunities to invest in line with ESG objectives, not least the opportunity to focus on social impact without forgoing financial returns.
- The private markets nature of the assets is not only a source of returns but allows investors to tailor assets to better meet their ESG, matching and risk management objectives.

## About Alpha Real Capital

Alpha Real Capital LLP is a specialist real assets investment manager focused on secure income strategies. We invest in UK and European assets with predictable secure long-term cashflows to help our clients meet their liabilities.

We provide market leading and innovative real asset solutions across a range of investments such as commercial ground rents, UK renewable infrastructure and social real estate, combining operational real estate expertise and fixed income skills.

**CDI series thought leadership titles** More available to view at alpharealcapital.com/news


**Social Real Estate**

A £50 billion secure income opportunity?


**Commercial Ground Rents**

Investment opportunity in a time of adversity


**Value drivers of long income property**

A high-level overview


**European Commercial Ground Rents**

An Introduction

Contact Alpha

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# Alpha Real Capital

**For more information about Alpha Real Capital LLP, its funds and key personnel visit: www.alpharealcapital.com**



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