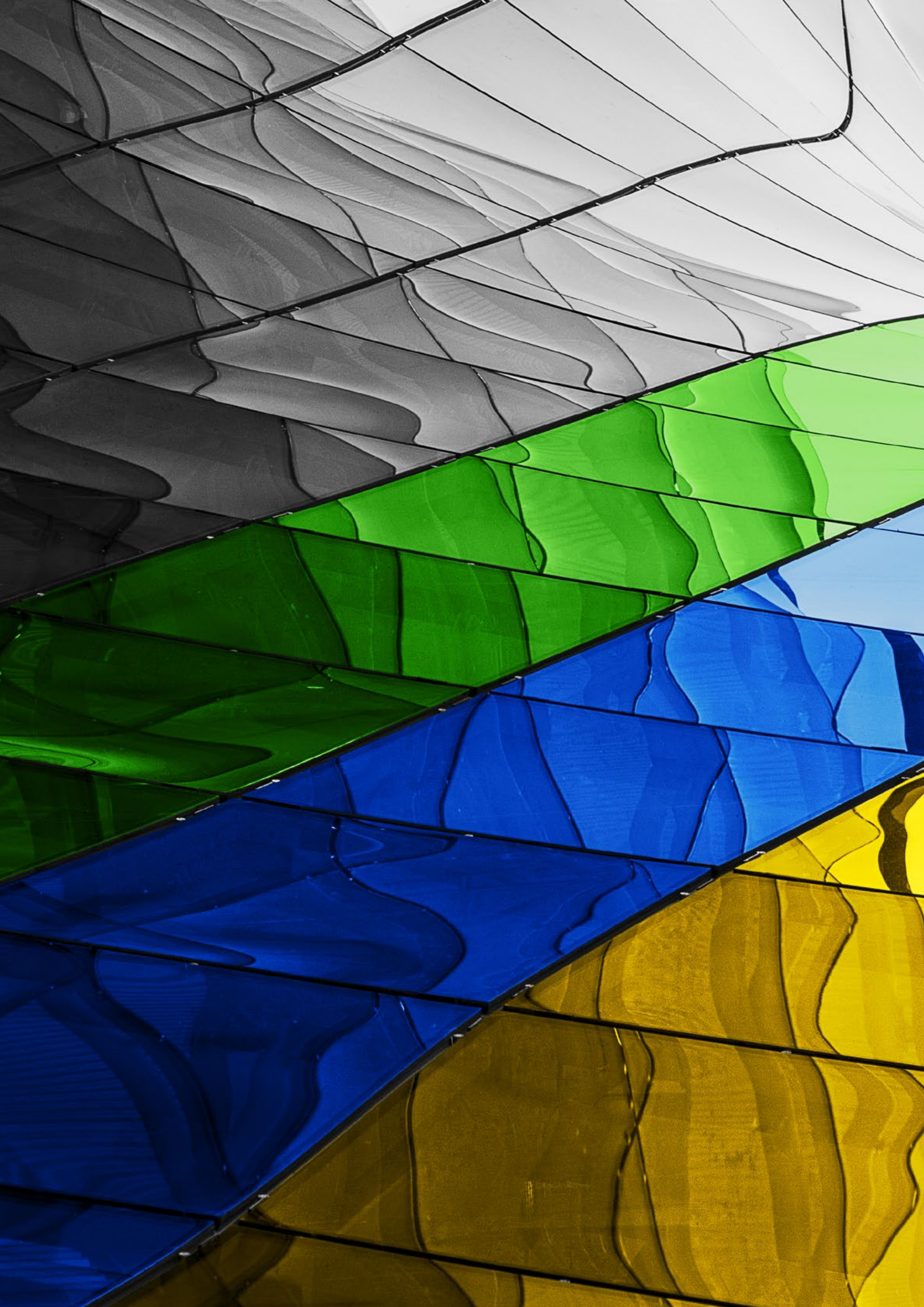
This document is for investment professionals and institutional/ qualified investors only. It is not to be viewed by, or used with, retail investors.

Real Assets Study

In search of resilience in an uncertain world

October 2019

For today's investor



Contents

4 Foreword by Euan Munro

5 About the research

6 Key Findings: Appetite continues to grow

9 Interview with Mark Versey, Chief Investment Officer, Aviva Investors Real Assets

10 Interview with Calum Brunton-Smith, director, KPMG Investment Advisory

12 The growing importance of ESG

14 Interview with Mirza Baig, Global Head of Governance, Aviva Investors

16 Resilience in the face of uncertainty

18 Interview with Louise Kay, Global Head of Client Solutions, Aviva Investors

20 Demand increases, supply remains tight

22 Interview with Iain Forrester, Head of Insurance and Pensions Solutions, Aviva Investors

23 Global challenges

25 Interview with Daniel Blamont, Head of Investment Strategy, Phoenix Group & Sindhu Krishna, Investment Strategy Manager, Phoenix Group

26 Key risks

Foreword by Euan Munro

Much has changed since we published our 2018 Alternative Income Study. At that time, the global economy was running along nicely, which was expected to bring an end to a decade of monetary easing by central banks; most major equity indices were surging; and talk of trade wars was dismissed as rhetoric rather than a major risk.

Fast forward to today, and a sense of unease has returned to financial markets. Growth is slowing; central banks, led by the US Federal Reserve, have done a U-turn on interest-rate hikes; the stack of negative-yielding bonds had reached $17 trillion in September, reflecting investor concerns; equities are down; and the prospect of trade wars has evolved into a key risk for the global economy.

Despite, or perhaps because of this, the growth in demand for real assets among institutional investors remains strong. This drove our decision in May 2018 to combine our Real Estate and Alternative Income teams into Aviva Investors Real Assets, and is why we have broadened the focus of our survey this year to cover all the key asset classes in the sector. We have also expanded the reach of our survey to 500 senior investment professionals at insurance companies and pension funds across Europe.

Given the political and economic backdrop, the continued appetite for real assets is perhaps unsurprising. The diversification and cashflow-matching characteristics such assets can offer against publicly-traded securities are well known. And, with bond yields likely to remain compressed, it is understandable that investors look to real assets for positive returns, or what is commonly referred to as illiquidity premia. Meanwhile, as European governments contemplate whether to turn on the fiscal taps to stave off recessionary pressures, state allocations to infrastructure in conjunction with private capital could provide another tailwind.

Another undeniable trend is the growing influence of environmental, social and governance (ESG) factors. Institutional investors, and the asset managers they partner with, need to demonstrate their allocations have a broader benefit than returns alone. There is an argument that integrating ESG into portfolios is more straightforward in the real asset world than it is for public assets like bonds and equities. As ultimate asset owners, investors are not far removed from other key stakeholders, and should therefore be able to exert more influence over decision-making.

These trends are all positive for real assets, but the sector is not without its challenges. With new entrants coming to the party and existing investors increasing their allocations, there is a risk of overcrowding in parts of the market, while liquidity remains a concern for some.

As ever, investors need to carefully consider all the opportunities and risks when determining their investment strategies. It promises to be another fascinating year for real assets.

Euan Munro
CEO, Aviva Investors

About the research

This research was conducted online from 30th April – 10th May 2019 by FTI Consulting's Strategy & Research team.

For the purposes of this analysis, we have grouped the following geographies across Europe as follows:

Please note that the standard convention for rounding has been applied and consequently some totals do not add up to 100%. For more information on the research methodology, please contact dan.healy@fticonsulting.com

Real assets definitions

Direct Real Estate: Long-lease and core balanced real estate investments across traditional and alternative sectors in Europe

Real Estate Debt: Senior debt secured on commercial property – offices, retail, industrial and hotels

Infrastructure Debt: Loans and bonds secured on infrastructure projects including PFI, hospitals, roads, schools and utilities

Infrastructure Equity: Low-carbon and social infrastructure project financing across sectors such as wind, solar, energy centres and biomass

Private Corporate Debt: Private placements and bilateral loans to a variety of sectors and issuers, ranging from investment grade borrowers to SMEs

Structured Finance: Bespoke deals across an array of opportunities, including CLOs, aviation, trade finance and other structured assets

Key findings: Appetite continues to grow

Despite global turbulence, investors continue to grow their allocations to real assets, even as they face challenges such as trade wars and the need to address ESG issues.

The flip side to growing demand is one of the major barriers to real asset investment: a lack of supply. Some investors are becoming wary of overpaying for a small pool of assets for which their contemporaries compete, but in which few will invest. This has led some to consider alternative routes of access – through pooling of assets with other investors to get access to larger projects (co-investment), or by exploring a more diverse range of assets to invest in.

As one investor told us: “Speed of deployment in the real assets arena can be challenging generally – and even more so in uncertain times. If there is a limited number of good quality assets, not everyone will be able to deploy as quickly as they think. Deployment and lack of supply overall is a risk.

“Assets with smaller pools – like equity-release mortgages – might trade more frequently than big-ticket portfolios of loans. A lot of people in my industry are thinking about investing in the same things, and if you go back to the last boom it can create a situation where investors have taken on a level of risk that, in 2-3 years’ time, will turn out to be egregious.”

While sovereign wealth funds led the way in real assets investment at the beginning of the decade, pension funds and insurance companies have become active investors in this area in recent years. At the same time, new types of projects demand greater emphasis on risk management and transparency.

The political arena is also driving interest in real assets, with both the Trump administration in the United States and the Boris Johnson-led government in the United Kingdom pledging large-scale infrastructure investment on the back of historically low interest rates.

The definition of a real asset investment is also evolving and expanding as innovation continues. Promises of improved digital infrastructure are not only likely to prove a vote winner, but are also set to provide secure new income streams for investors. These include 5G infrastructure, data centres, and charging points for electric vehicles.

Transport infrastructure continues to be fertile territory, with electric vehicles in the vanguard. Darryl Murphy, Head of Infrastructure Debt at Aviva Investors, says: “The growth of electric vehicles has taken place much faster than expected and could have a significant influence on infrastructure over the next ten years.”

Real estate is also complex, fast-changing and affected by political and societal changes. With retail property – particularly in the United States and Britain – impacted by a structural shift towards e-commerce, safe havens such as real estate debt secured against non-retail real estate are growing in their appeal.

According to Cass Business School figures, the outstanding UK loan book value of £164.5bn at year-end 2017 was allocated as follows: £124.5bn held by banks & building societies (75.5 per cent), £23.9bn (14.5 per cent) by insurance companies and £16.1bn (9.8 per cent) by other non-bank lenders. This compares with banks providing 98 per cent of UK lending in 2007.

Interest rates are a cause for concern. However, it is unclear whether this reflects a longer-term fear they will rise, or the shorter-term uncertainty associated with a recessionary or deflationary environment.

Lower interest rates may extend the real estate cycle, as yields continue to be above the bond market’s, but the counter-argument is that occupational risk in some territories is rising. Yet in mainland Europe, demand remains robust in office and logistics real estate.

With real estate generally judged to be in the late stages of its current cycle, there is growing interest in ’alternative’ asset classes such as build-to-rent residential or medical property.

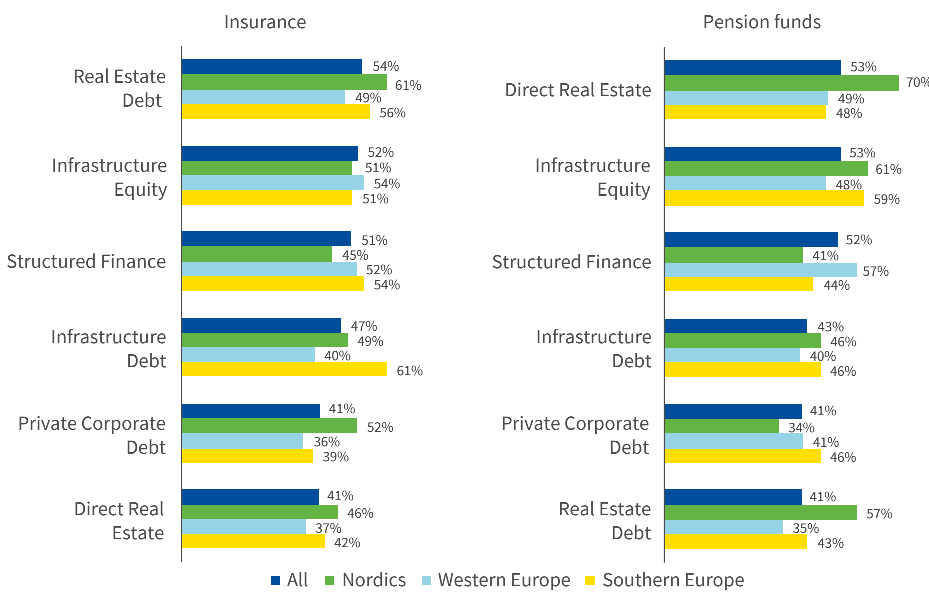
Overall, real assets look set to continue to grow, albeit grappling with the same global issues other asset classes face in 2019.

Which of the following real assets do you expect to increase investments in over the next 12 months?

Over half of insurance experts expect to increase investments in real estate debt (54 per cent), infrastructure equity (52 per cent) and structured finance (51 per cent) in the next 12 months.

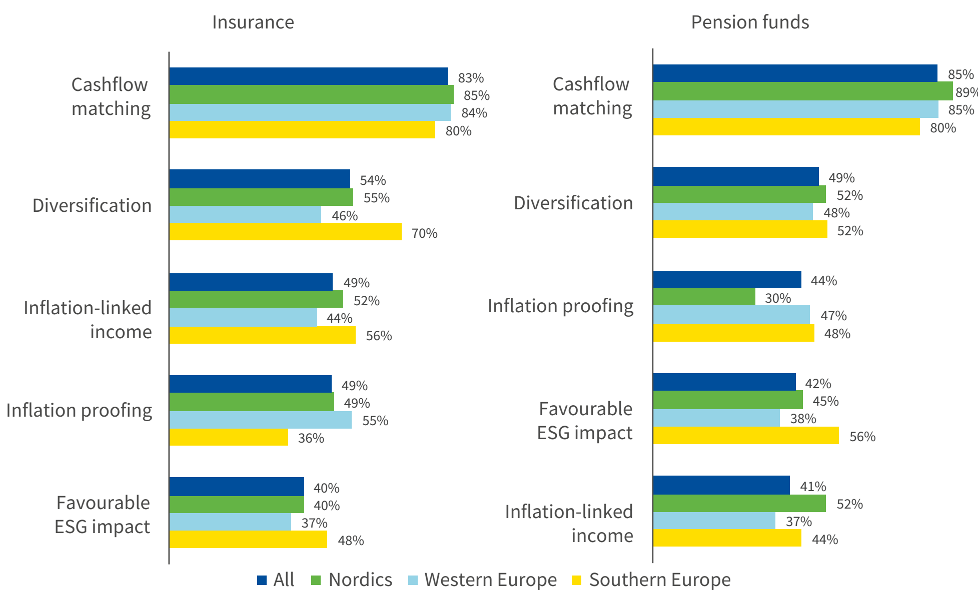
Pension funds expect to increase investments in direct real estate (53 per cent), infrastructure equity (53 per cent) and structured finance (52 per cent).

Figure 1. **Increasing real assets investment over next 12 months**



Source: Aviva Investors, May 2019

Figure 2. **'Integral' drivers when investing in real assets: European regional perspective**



Source: Aviva Investors, May 2019

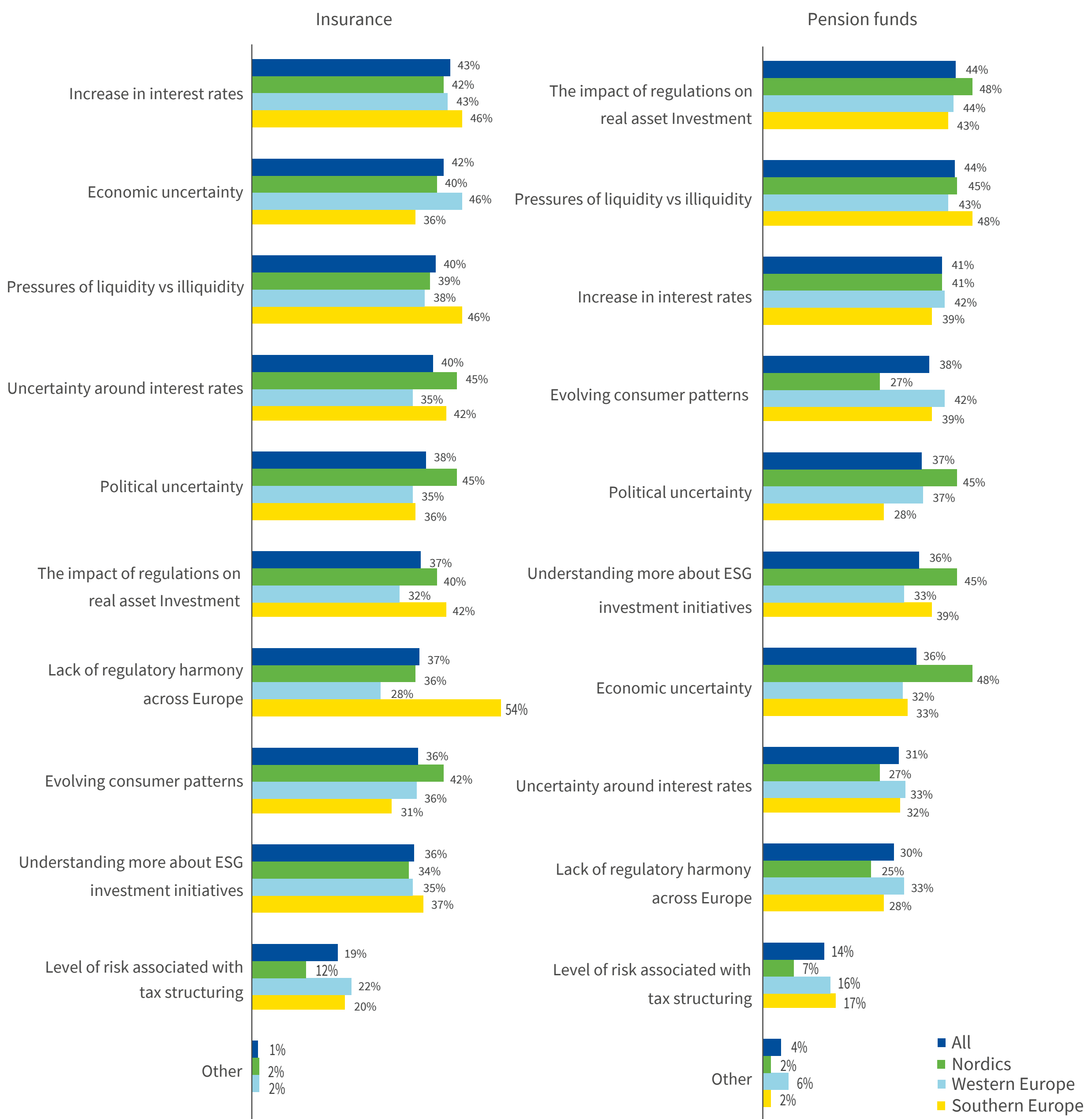
Over half of insurance experts expect to increase investments in real estate debt (54 per cent), infrastructure equity (52 per cent) and structured finance (51 per cent) in the next 12 months.

Pension funds expect to increase investments in direct real estate (53 per cent), infrastructure equity (53 per cent) and structured finance (52 per cent).

Which of the following do you believe to be very challenging when investing in real assets in Europe over the next 12 months?

- The 'impact of regulations on real asset investment' and 'pressures of liquidity vs illiquidity' (both 44 per cent) are deemed most challenging for pension funds.
- Both insurance (37 per cent) and pension funds (30 per cent) feel a 'lack of regulatory harmony across Europe' is very challenging to investment (rising to 54 per cent for insurance in Southern Europe); while a similar percentage cite the pressure of understanding 'evolving consumer patterns' (insurance: 36 per cent; pension funds: 38 per cent).

Figure 3. **Challenges for European investment over next 12 months**



Source: Aviva Investors, May 2019

Interview with Mark Versey, Chief Investment Officer, Aviva Investors Real Assets

Q: What types of assets will Aviva Investors Real Assets be investing in over the coming years?

A: We have spent a lot of time thinking about our real assets investment philosophy and where to invest across Europe. We've identified 11 cities in Europe and five UK clusters that we think offer the best growth opportunities for investment.

For us, it is about creating places where people want to live, work, play and learn. These are large-scale developments with a mix of retail, office and residential. We have some exciting projects underway in Paris and London, in particular.

We really like the alternatives sector in the UK. Care homes and purpose-built student accommodation are the two standout use cases we've been investing in recent months. Both have great covenant strength and offer stable long-term cash flows. Over time we expect that model to be replicated across Europe, underpinned by structural societal shifts.

Q: How will you tackle the shortage of supply of investment opportunities?

A: We have 320 people across our pan-European platform and over 100 of those are dedicated to the sourcing and acquisition of real assets across Europe.

Our large off-market capability means we see assets much earlier and can work on the structuring and even get involved in the design.

Q: What impact would a rise or fall in interest rates have on the real assets world?

A: We see low interest rates continuing in the medium term, and that is great for real asset pricing. The risk would be a sharp increase in interest rates, which would affect borrowing costs and could cause real estate and infrastructure projects to fall in value. A longer term, more gradual rise in interest rates is fine; investors cope with that very well.

Q: What global capital flows do you foresee in the near term?

A: A lot of global investors are looking to invest into UK commercial property, but are waiting to push the button on investment due to uncertainty around Brexit. Today, the global flows are toward continental Europe. And because we have a large real estate business in Europe, we can act as a conduit for those global flows into European cities we like. The demand for real assets remains strong from global players.

Q: Why was Aviva Investors Real Assets created?

A: The boundary between the different asset classes in the private market has been blurring. At the same time, investors are looking to increase their allocation to real assets by 50 per cent by 2025, a huge transition.

Investors are looking across the spectrum and increasingly want multi-asset portfolios, with an outcome-oriented focus. Clients typically want growth, or long income, or a private debt portfolio. What we are able to do is mix together infrastructure, real estate and private debt to provide those three outcomes.

Clients are also able to co-invest, both with each other and alongside Aviva. The real assets platform gives us even greater scale, which enables us to execute some of the larger deals in the market. Early access and being involved in the structuring means better covenants, better yield opportunities, and fast deployment of capital on behalf of our clients.

"For us, it is about creating places where people want to live, work, play and learn. These are large-scale developments with a mix of retail, office and residential."

Mark Versey
Chief Investment Officer,
Aviva Investors Real Assets

Interview with Calum Brunton-Smith, Director, KPMG Investment Advisory

Q: What are the key drivers when you are advising clients on their asset allocation?

A: Key for us is understanding our clients' objectives, and then developing an investment strategy to achieve them with as much certainty as possible. The three key pillars of our approach are: shape and certainty of the investment outcome; suitable balance between liquid and illiquid investments; and true diversification across drivers of risk.

Across our client base funding levels have been steadily improving via a combination of liability hedging and sensible growth strategies. Importantly, we believe strategy setting needs to evolve as funding and the environment change. Within our clients' portfolios, part of this evolution over the past 5-10 years has been an increased focus on real and contractual assets which, in our view, bring greater certainty of delivering the required return.

Q: What types of real assets investments do you currently favour?

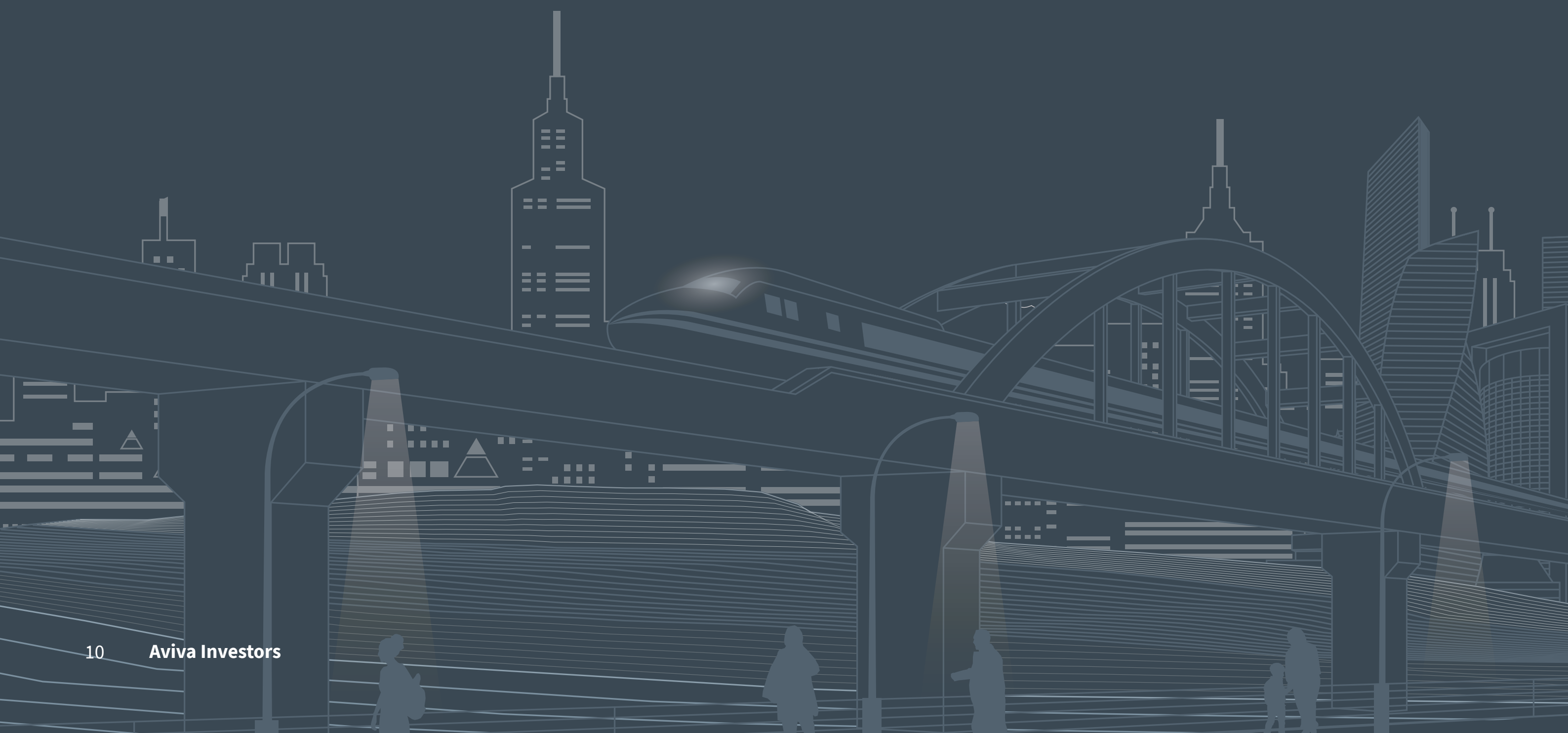
A: Real assets have always featured in all our clients' portfolios. The risk/return profile of these assets typically offers attractive risk-adjusted returns; we also see real assets as a genuine diversifier to the core asset classes pension schemes invest in. Alongside this, the nature and term of the underlying cash-flow profile is typically positively aligned with the needs of a pension scheme.

Across our client base we have material exposure to long lease real estate, private corporate debt, real estate and infrastructure debt, infrastructure equity and structured finance. These asset classes all fit in well with our philosophy of developing investment strategies with a high degree of certainty in terms of return and cash-flow delivery. We continue to proactively research these markets to identify new opportunities to bring to our clients.

Q: What is your take on UK and global investment right now?

A: There are clear risks on the horizon from both a domestic and global perspective. A lot of these risks are difficult to quantify in terms of outcome and implications for markets (i.e. Brexit, trade wars, etc). Additionally, interest rates and inflation continue to pose a material risk to pension schemes and, in the absence of a strong view, we continue to support mitigating this risk despite current yield conditions.

From a strategic perspective, we continue to advise our clients to reduce/remove risks and exposures where we have limited conviction in them being rewarded for the risks taken. This has resulted in us increasing or introducing exposures that mitigate risks and/or are more certain to deliver returns commensurate with the risks being taken.



Q: What other risks do you foresee for real assets?

A: Different risks will impact the different areas of the real assets market. Whilst there are many considerations when investing in real assets (e.g. liquidity, RPI reform, creditworthiness, political, regulation, etc), we can identify a few specific examples. The uncertainty of Brexit is creating concern for the UK and European property market – whilst this is a clear risk, we prefer the higher-quality, cash-flow-generative nature of long-lease over balanced in this environment. Political risk for infrastructure investments is a material concern both domestically and globally – again, we prefer strategies that focus on clear and positive direction (e.g. social trends, environmental benefits, etc) to help mitigate this risk. The global economic backdrop remains stretched and most credit markets are late in the cycle – we maintain conviction in many credit-based opportunities, but we do have a preference for the safer end of most markets (i.e. direct lending, structured finance, etc.) where we believe the risk/return profile is most attractive.

Q: How are regulatory issues affecting real assets?

A: Regulatory changes have helped increase demand from institutional investors. On the insurance side, we have seen demand for real assets rise as insurers look for more yield on a capital-efficient basis. On the pensions side, this demand has been longstanding, but the breadth of opportunities has increased.

The DWP's recent upgrading of ESG risks to "financially material" has stimulated a lot of debate about trustee and corporate beliefs in this area. In our experience, the majority of trustees have embraced this regulatory change positively, committing to review their existing and future investments through an ESG lens. There is a subset of real assets that deliver tangible positive action on both ESG outcomes (e.g. renewables, green bonds, etc.) and helping to meet long-term funding requirements. This is an example where regulation has helped trustees and companies align beliefs and action on a very important area and, in our view, that can only be a good thing.

Q: How do you view the supply of real assets for investment?

A: The opportunity set in real assets has expanded materially over the past 5-10 years, with many of these asset classes becoming much more mainstream. As a result, these are fast-growing markets with a lot of innovation going on as every underlying sleeve reacts to both investor demand and the fast-changing landscape.

As we do across all asset classes, we will continue to scrutinise the relevance of each of these real asset classes for our clients. We have seen opportunities look attractive and migrate to a position where we would no longer be comfortable seeing our clients invest. As such, we are continually looking for new opportunities as the environment and the needs of our clients change over time.

> *"Within our clients' portfolios, part of this evolution over the past 5-10 years has been an increased focus on real and contractual assets which, in our view, bring greater certainty of delivering the required return."*
>
> **Calum Brunton-Smith**
> Director, KPMG,
> Investment Advisory

The growing importance of ESG

ESG issues have soared in importance in investors' minds over the last 12 months, with nine in ten of those polled considering ESG to be important in investment decision-making.

For insurers (54 per cent) and pension funds (57 per cent), the 'ability to quantify ESG ratings' is an area that respondents particularly look for when considering ESG aspects of investments.

Insurers are also more likely (50 per cent) than pension funds (41 per cent) to consider the 'transparency of asset managers' ESG investment approach'.

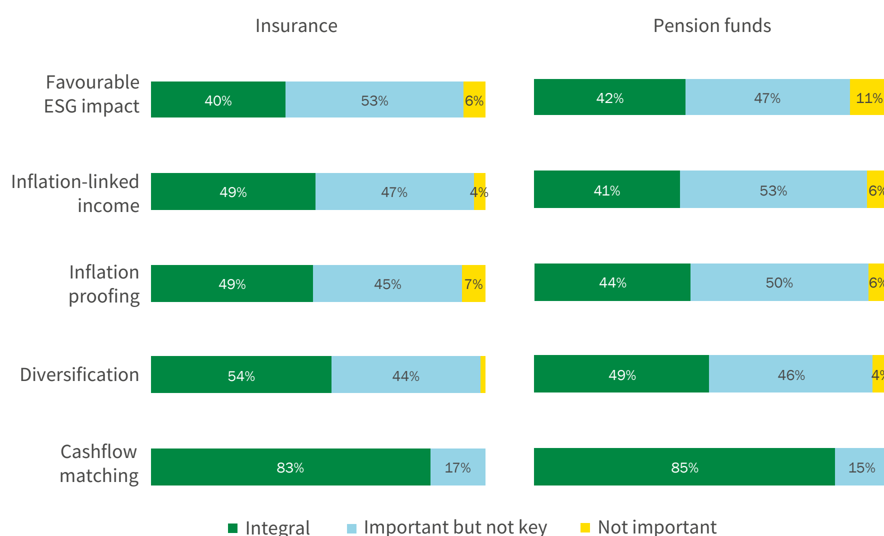
Of this nine, 40 per cent of insurers and 42 per cent of pension funds consider a 'favourable ESG impact' of real assets to be integral to their investment decision-making, with 53 per cent and 47 per cent respectively citing ESG as 'important but not key'. Just one in ten claim ESG is not important.

For insurers (54 per cent) and pension funds (57 per cent), the 'ability to quantify ESG ratings' is an area respondents particularly look for when considering the ESG aspects of investments. For Nordic insurers (67 per cent) and pension funds (64 per cent), there is a much higher focus on 'integration of ESG into the investment process'– 14 and 13 percentage points more than Europe overall, respectively.

Insurers are also more likely (50 per cent) than pension funds (41 per cent) to consider the 'transparency of asset managers' ESG investment approach'.

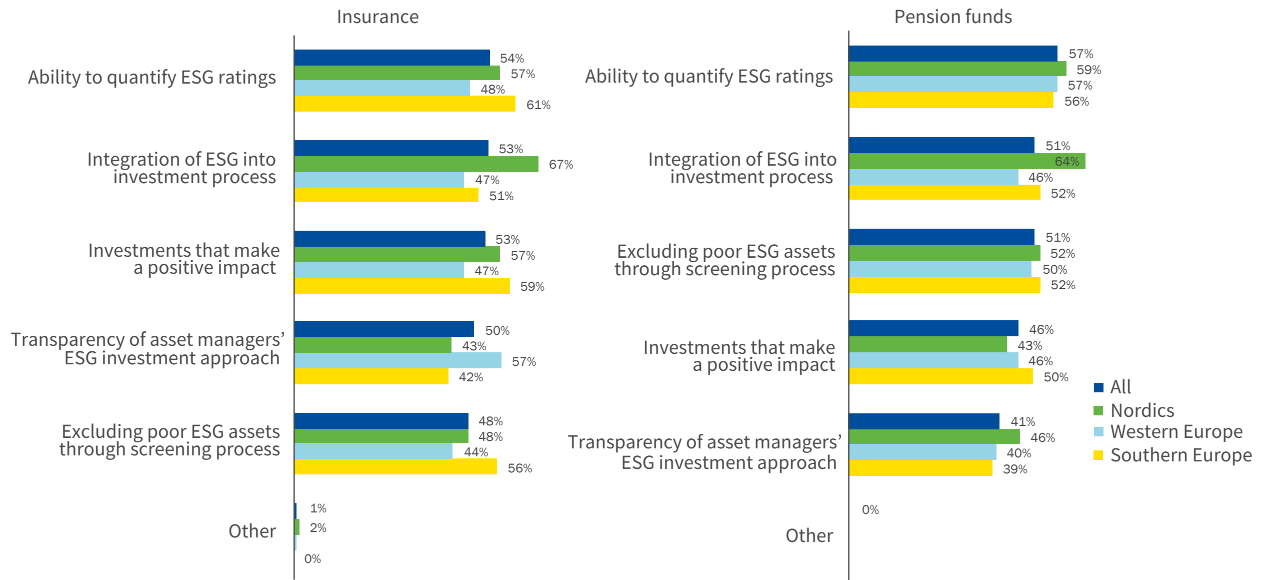
'Social infrastructure' is the most important socially-responsible investment to include in insurance (60 per cent) and pension fund (57 per cent) portfolios. Three-quarters (73 per cent) of insurers in Southern Europe think 'energy-efficient real estate' is particularly important, while 52 per cent of Nordics look to 'renewables', 8 percentage points higher than Europe overall, and 15 percentage points more than Western European insurers.

Figure 4. **How important are each of the following when considering investing in real assets?**



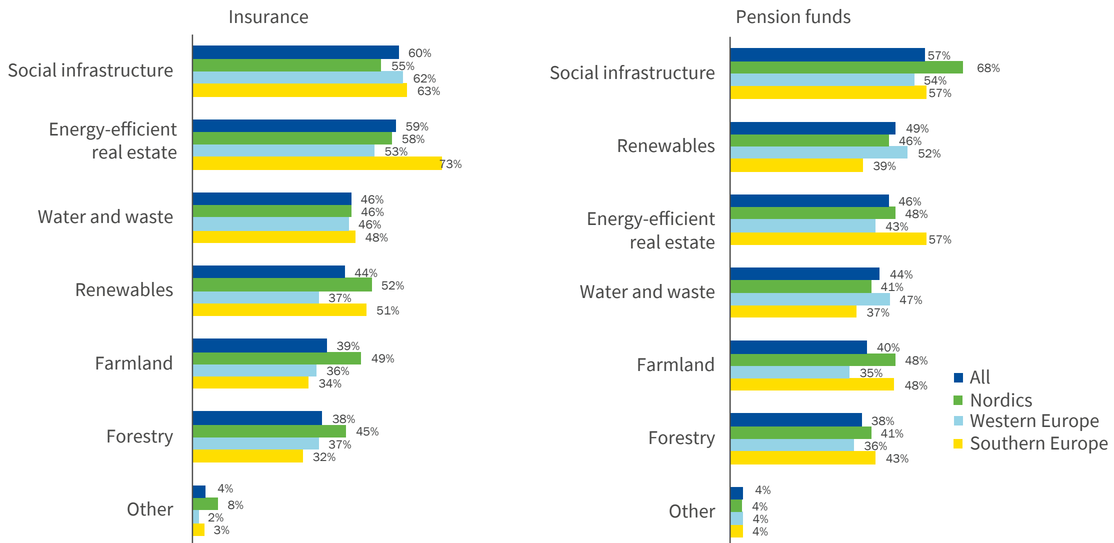
Source: Aviva Investors, May 2019

Figure 5. **What do you particularly look for when considering ESG aspects of your investments?**



Source: Aviva Investors, May 2019

Figure 6. **Which of the following socially responsible assets are particularly important to include in your portfolio?**



Source: Aviva Investors, May 2019

Interview with Mirza Baig, Global Head of Governance, Aviva Investors

The poll of investors has thrown up some interesting results. It confirmed broader trends we are seeing across the market – that ESG is important, and increasingly so.

Q: Why do Nordic investors pay particular attention to ESG issues?

A: The Nordics have been at the forefront of ESG for 20 years, long before it was fashionable in other markets. They started off with an exclusionary approach, saying "we will not invest in X" based upon some form of negative screening.

They subsequently evolved and the research reflects ESG is influencing which assets are acquired and what is expected of you as a responsible owner. They are now pushing their boundaries even further, asking "how do you quantify the social impact of a particular investment?". Where the Nordics go, other markets eventually follow and catch up.

Q: What is Aviva Investors Real Assets' approach to ESG?

A: ESG has been part of our heritage for decades. We tried to leverage learnings and high-level principles from our liquid strategies and reinterpreted them for real assets. However, we are very conscious our ESG approach needs to be bespoke and tailored for the unique ESG challenges and opportunities associated with real assets. Real assets are complicated and there is a plethora of indicators we could look at. So, we have tried to move beyond a black and white approach and created a balanced ESG scorecard to assist us in our evaluation.

We try and identify the core indicators of 'e', 's' and 'g' respectively and weigh up the positives and negatives. We also look at an asset or transaction's contribution to the Sustainable Development Goals.

We ensure there is a minimum standard, whether we build, acquire or are lending against an asset. We may do an ESG gap analysis and decide to fund or purchase an asset if we can see a pathway to closing that gap in an efficient and cost-effective way.

However, there have been transactions where we have not been satisfied that a built asset meets our minimum criteria and we have passed up on the opportunity, even though in the short term it appeared commercially attractive.

Q: How do you measure the impact on society of a real asset?

A: The social component of a transaction is always the hardest element to quantify. We look at several indicators such as job creation and the extent to which the asset lends itself to inclusive growth.

In Manchester, for example, we are involved in a substantive regeneration project and looked at the types of employment that would be generated and got a sense of comfort that it would be inclusive and tilted towards supporting students coming into the workforce from local universities.

Q: What is the outlook for the coming years for ESG and real assets?

A: The interesting thing about real assets is there is not only an increasing interest in ESG but an increasing interest in the asset class as a whole, in part due to the low-yielding environment.

So, in terms of client ESG reporting expectations and investment objectives, this is evolving simultaneously. We are working with our clients on defining what is possible within real assets, whether it be on the infrastructure side or real estate.

What is unique within real assets is longevity and lack of liquidity. The reputational risks associated with these assets are amplified because of physical ownership.

"ESG has been part of our heritage for decades. We are very conscious our ESG approach needs to be bespoke and tailored for the unique ESG challenges and opportunities associated with real assets."

Mirza Baig
Global Head of Governance,
Aviva Investors

Resilience in the face of uncertainty

Strong demand and limited supply of blue-chip real assets continue to underpin their value around the world.

As one investor told us: "A lot of the business that we write is annuity or long-dated, so we are looking to assets in the UK and Europe where the profile is also annuity or long-dated.

"We have been heavily involved in commercial real estate lending for a number of years, but the current appetite for risk capital is changing, which is requiring us to think about alternative asset classes and parts of the world outside our traditional focus as well.

"We currently favour commercial mortgage loans, infrastructure debt and equity-release debt, but that will change as the real assets sector evolves and new opportunities arise."

Pricing is at historically high levels but some global cities, such as Paris, are seeing prime yields of around three per cent. Investors are comfortable with this return in a low-bond-yield environment as long as a property is well-let. In fact, vacancy rates in Paris hover between one and two per cent, demonstrating the strength of demand for space.

Manchester is another success story, with a good demographic profile and high levels of education, as well as a large pool of graduates who are increasingly inclined to stay in the city when they finish university, adding to its appeal.

Political risk, however, is considered a threat to the resilience of some parts of the real assets universe. Brexit is viewed as a threat by all investors, but there are also concerns in the UK around the intentions of the opposition Labour Party to re-nationalise parts of the country's infrastructure.

Another area under threat is retail real estate. In the UK and the United States, values fell by more than ten per cent between mid-2018 and mid-2019, and e-commerce now accounts for up to 20 per cent of total retail sales. This has created an over-supply of secondary retail space with little prospect yet of being re-purposed. In particular, debt is being withdrawn from the retail real estate market, and loans to finance the sector are becoming more expensive.

Offices will also have to adapt as the rise of flexible working takes hold; flexible office groups now account for over 15 per cent of annual office demand in core cities.

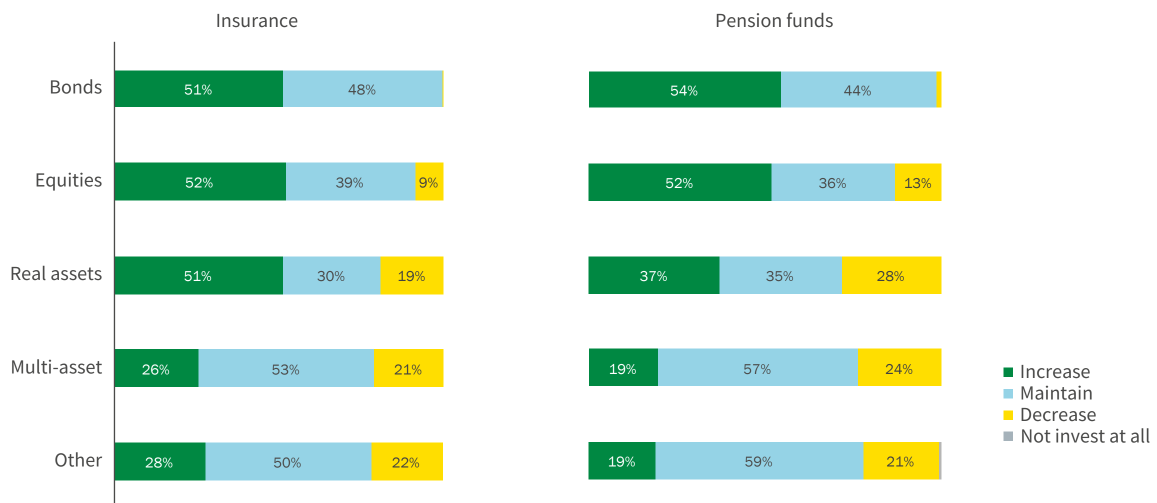
While structural changes are having a bigger impact than ever before, in particular on real estate, the biggest talking point continues to be where the sector is in its traditional cycle.

In a May 2019 research paper, 'Mastering the real estate cycle', Aviva Investors' Director of Research, Real Assets, Chris Urwin argued that real estate is more cyclical than other investment classes, firstly due to the nature of development, with long lags between conception and completion of new buildings. The second factor is the widespread use of leverage, adding to the volatility of returns. We created a toolkit of 15-17 different metrics to assess the main factors driving the real estate cycle, and found that, among Europe's key capitals, risk is higher in Berlin than Paris and London. Compared with previous late-cycle markets, however, lending remains relatively restrained – making the real estate component of the real assets world more resilient than at many points in the past.

How do you expect to change the following investments over the next 12 months?

- 51 per cent of insurers expect their investments in real assets to increase, with 30 per cent expecting to maintain their current allocation.
- Pension funds are less likely to increase than their insurance counterparts (37 per cent), but expect to maintain their investments (35 per cent).
- Just 19 per cent in insurance and 28 per cent in pension funds expect to decrease their investments, despite socio-economic fears across Europe.

Figure 7. **Expected change in investments over next 12 months**



Source: Aviva Investors, May 2019

Interview with Louise Kay, Global Head of Client Solutions, Aviva Investors

This study, and our conversations with clients, show investors are increasing their allocation to real assets globally. This is being driven by the need for diversification of yield against a backdrop of low growth and low interest rates, as well as specific needs among investors to achieve their financial objectives.

For example, the majority of defined benefit pension funds in the UK are closed and need to pay scheme members a regular income. This is driving schemes to increase their allocation to a variety of real assets, including private debt, real estate finance and infrastructure debt as they seek to deliver a regular income stream while also protecting against inflation.

Regulation is acting as a catalyst for demand. Insurers across Europe and the world are typically allocating to real assets due to favourable treatment under Solvency II.

There is also an extension of interest in real estate into alternatives such as social housing and healthcare. Clients not only look at these as alternative sources of income, but as an opportunity to invest in society as well.

Q: How are institutional investors accessing real assets?

A: No two investors are the same, but typically you find that the largest come to us wanting exposure to a specific asset class. For example, in the UK and the US this is often domestic real estate.

Large investors are also increasingly seeking to directly invest in assets. Sometimes they will be interested in co-investing, or in a joint-venture with an asset manager. Some sovereign wealth funds will have a degree of expertise internally where they'll be allocating to deals themselves. Look around us in London and you'll see many foreign-owned buildings. But typically, they are also looking for partners that can help them source deals because it's very labour intensive to develop a wide reach across real assets markets.

Alternatively, some investors trying to secure a long-term income stream may not be as concerned about allocating to all the individual components, and they might not have the governance to do that either. In these instances, clients are wanting multi-asset portfolios. We will create a diversified portfolio blending different asset classes, based on where we see the most attractive investment opportunities over the long term.

Q: What are the benefits of a multi-asset strategy for real assets exposure?

A: Ultimately it gives investors access to a wider range of strategies and that means we can often help allocate their capital more efficiently.

It also gives us the opportunity to arbitrage between opportunities in different asset classes. This is an attractive proposition, particularly for those who have an outcome requirement and don't necessarily have the governance framework and resources in place to invest individually in all the underlying asset classes.

Q: What are the main challenges investors are wrestling with?

A: Clients' main challenges typically relate (directly or indirectly) to the low interest rate and inflation environment. Most have large exposures to conventional bonds, and they struggle to achieve acceptable levels of yield. Real assets offer an illiquidity premium alongside diversification, which is why we are seeing a huge trend around the world.

Cashflow matching is also a big factor. Pension funds have to pay out a set amount to pensioners every month. To manage and to build a portfolio that does what it says (i.e. cashflow matches), they need to access secure income to meet these liabilities.

Q: What are the types of questions an institutional investor should ask an asset manager when exploring an allocation to real assets?

A: Due diligence is critical to any investment, and there is no one-size-fits-all approach as every investor has a unique set of circumstances. The types of questions we would always encourage an investor to ask include: does the manager have the depth of relationships in the market to access all the right deals?

You need to have scale and skill to do that, as you can then create value by looking at off-market deals. This is important because you can pick up returns over and above the illiquidity premium and obviously you can obtain great diversification benefits as well.

"Investors are increasing their allocation to real assets globally. This is being driven by the need for diversification of yield against a backdrop of low growth and low interest rates."

Louise Kay
Global Head of Client Solutions,
Aviva Investors

Demand increases, supply remains tight

With growing demand for real assets, is the supply of investment opportunities enough to satisfy this hunger?

Real estate debt is the most popular field for insurers, with 54 per cent of those polled expecting to increase their investments in the next 12 months, and 61 per cent of those in the Nordics eager to increase their allocations. Among pension funds, 70 per cent of Nordic investors wish to grow their exposure to direct real estate, compared with 53 per cent of pension investors overall.

In fact, demand is strong overall, with insurance groups and pension funds all strongly favouring infrastructure equity and structured finance by expecting to increase investments over the next 12 months. However, supply is considered a problem. Despite expecting the largest increase in investment to be in real estate debt, 37 per cent of insurers believe supply to be low. Similarly, a quarter believe infrastructure equity and structured finance supply to be constrained.

The barriers are many and varied.

Illiquidity is cited as the biggest issue, with large infrastructure and real estate assets traditionally difficult to trade. This partially explains the rise of new vehicles like the UK's IPSX, an index that seeks to allow institutional investors to trade in and out of listed shares in individual assets.

Investment in European real estate during 2019 was anticipated to be led by Asian investors, according to PricewaterhouseCoopers and the Urban Land Institute's 2019 Emerging Trends report.

This showed that 69 per cent of respondents to its survey thought investment from Asia would increase, with Japanese pension funds expected to lead the way after the nation's Government Pension Investment Fund, with $1.2 trillion of assets, was permitted to invest in real estate for the first time.

The weak pound is also expected to drive global investors towards UK infrastructure and real estate assets. However, as our survey shows, the difficulty in benchmarking performance, length of time to deploy capital and even a lack of in-house expertise on alternatives can form other barriers.

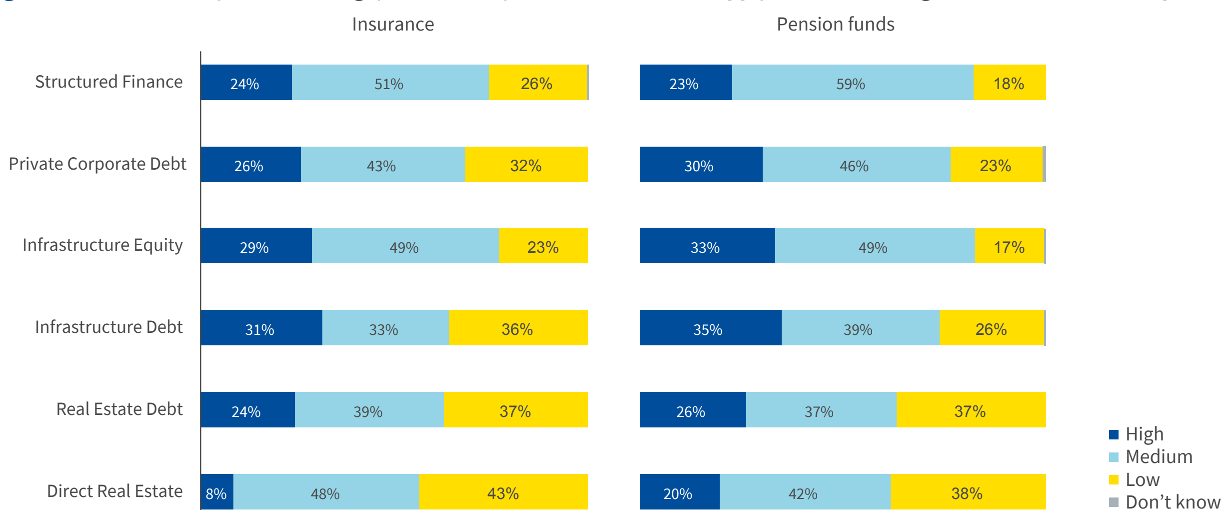
Some global investors overcome these by investing in large-scale new social-infrastructure projects or place-making, gaining access to prime projects from their inception.

In Manchester, we are adopting this approach on behalf of investors at Enterprise City, built on the former site of Granada television studios in the St John's area. Working with developer Allied London, the aim is to establish one of the UK's leading digital, media and enterprise clusters.

Once completed, Enterprise City will be over one million square feet of commercial mixed-use space, including workspace, TV and film studios, hotel/leisure and various property infrastructure across ten buildings. It will provide a place for modern industry in Manchester.

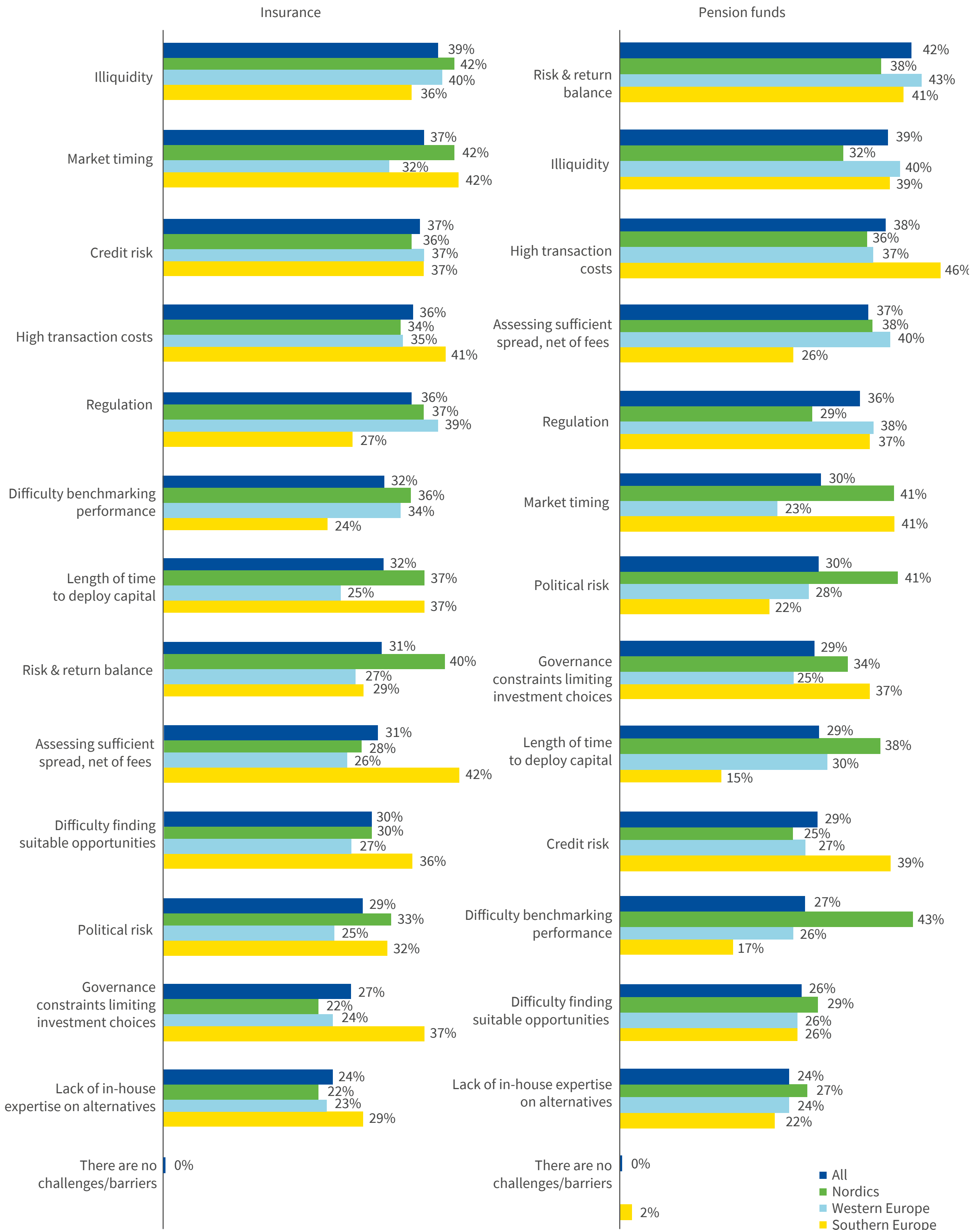
This approach is one way to satisfy strong investor demand and mitigate the limited supply of real assets.

Figure 8. **To the best of your knowledge, how would you rate the level of supply of the following real assets across Europe?**



Source: Aviva Investors, May 2019

Figure 9. **What would you identify as the biggest challenges/barriers to your institution either investing in, or increasing its allocation to real assets?**



Source: Aviva Investors, May 2019

Interview with Iain Forrester, Head of Insurance and Pensions Solutions, Aviva Investors

We have seen insurers across Europe look to transition their portfolio towards real assets over the last few years and we expect that trend to continue, with 51 per cent of insurers anticipating an increase in their allocations.

Q: Why do you think insurers are looking to increase allocations to real assets?

A: Insurers find themselves in a challenging position – they are looking to improve returns in a low-yield environment while being subject to risk-based capital regimes.

An allocation to real assets can help improve returns and portfolio diversification. In turn, improved diversification helps manage risk, as does the structural downside protection offered by real asset allocations.

Q: What are the main barriers to increased investment in real assets for insurers?

A: Illiquidity, market timing and credit risk were the three key barriers highlighted by insurers in this survey.

On illiquidity, insurers have to understand the liquidity profile of their liabilities as well as the liquidity, or otherwise, of their assets. This determines their capacity to allocate to illiquid assets within each portfolio, and over what time horizon. Liquidity management is an area that has had a significant increase in regulatory scrutiny in recent years, and we see that as a continued area of focus.

The concerns around credit risk are also influenced by the private nature of these assets. Successful investment in private credit relies on deep credit capabilities to make sure the risk assessment carried out at the point of investment really does stand up to the challenges and rigour of an insurance company's requirements.

In respect of market timing, we see insurers looking for access to a broad range of real assets. This then allows them to take advantage of opportunities as they arise, both within and across asset classes, throughout the investment period.

Q: Is there a concern about the supply of suitable investment opportunities in real assets?

A: While some areas of the market are tighter from a pricing and supply perspective, we continue to see a range of opportunities. We're seeing interesting opportunities in structured finance – for example, in insured and guaranteed transactions. Real estate debt is another asset class where pockets of value exist despite high demand.

"An allocation to real assets can help improve returns and portfolio diversification. In turn, improved diversification helps manage risk, as does the structural downside protection offered by real asset allocations."

Iain Forrester
Head of Insurance and Pensions Solutions,
Aviva Investors

Global challenges

While real assets are seen as a safe haven by many global investors, trade wars and financial instability are creating uncertainty.

Both insurance (44 per cent) and pension funds (38 per cent) consider 'trade wars between nations' as both likely and a concern to their real assets investments in the next 12 months. Insurance (66 per cent) and pension funds (50 per cent) in the Nordics are much more fearful of 'trade wars' than their regional counterparts.

Lack of clarity over future trading relations between Britain and the European Union is also a concern for one in three of those polled, with respondents in southern Europe – where economic performance is weaker and where collateral damage could therefore be greater – the most concerned.

An international slowdown would have an impact on real estate occupational demand, although there is also an argument that infrastructure spending could increase as one of the few ways to stimulate economies, with few other tools left in governments'/states' armouries.

According to the OECD, advanced economies will spend just 1.77 per cent of their combined gross domestic product on debt interest in 2019 – the lowest since 1975 and down from a peak of 3.9 per cent in the mid-1990s. This comes despite the large debt accumulated by many countries since the financial crisis, which has risen from 45 per cent in 2001 to 76 per cent this year, according to the IMF. There is still leeway for spending on infrastructure, digital connectivity and environmental improvement.

The prospect of 'increasing populism/political extremism' in Europe continues to cast a shadow over real asset investment (insurance: 39 per cent; pension funds: 43 per cent).

While respondents are primarily concerned about volatility and unpredictability, there is also a fear that political risk could lead to nationalisation or disruption in a world which bases its appeal on reliable income streams. 'Financial instability', however, is perceived to be the most likely and concerning possibility (insurance: 49 per cent; pension funds: 45 per cent).

Four in ten insurers (43 per cent) and pension funds (40 per cent) fear 'regulatory interference', which again could be seen as a rise of interventionism by populist governments. However, global change can also mean opportunity, particularly in an era of knowledge capitalism, according to Aviva Investors' Director of Research, Real Assets, Chris Urwin.

In a study, 'Talent, clusters and scale' published in June 2019, Urwin highlights how cities are evolving, with new characteristics defining success on top of the traditional benefits of geographical location and access to suppliers and consumers.

In an era of 'knowledge capitalism', where a city's success is defined by its ability to facilitate knowledge-exchange and information-sharing to nurture the creation of ideas, cities need:

- **Talent – with deep pools of highly-skilled labour, allowing them to thrive. Nothing boosts a location more than access to highly-skilled people.**
- **Clusters – success breeds success in the era of knowledge capitalism, allowing organisations to feed and grow from each other, adding productivity overall.**
- **Scale – co-location facilitates the exchange of goods and ideas, catapulting growth at an exponential rate the bigger a location gets**.

As global challenges grow, investors are increasingly likely to combat them by focusing on infrastructure and real estate in fast-growing locations which can support the growth of knowledge capitalism.

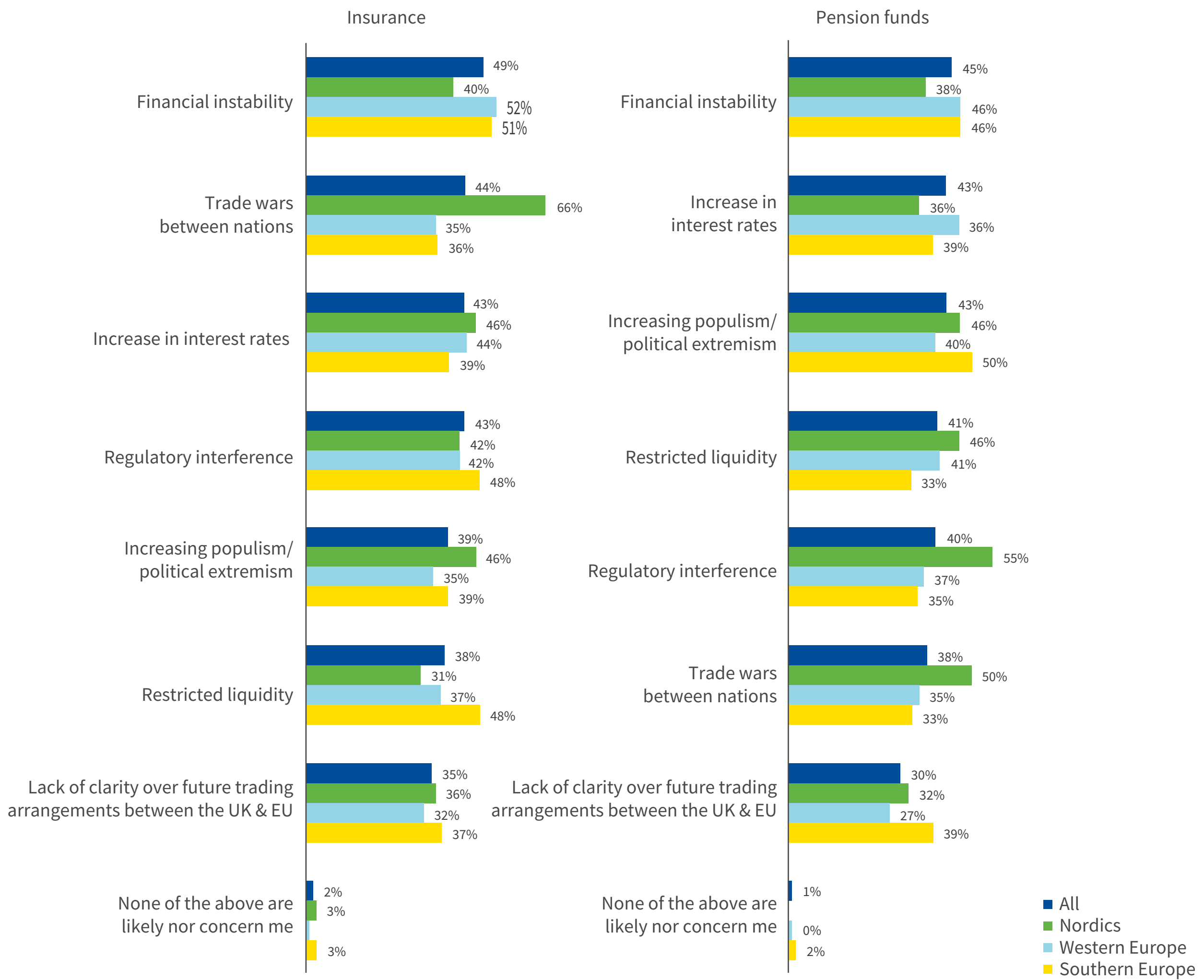
The two European cities considered by our research team to have the best 'Future City' prospects are Paris and London.

Both insurance (44 per cent) and pension funds (38 per cent) consider 'trade wars between nations' as both likely and a concern to their real assets investments in the next 12 months.

As global challenges grow, investors are increasingly likely to combat them by focusing on infrastructure and real estate in fast-growing locations which can address the growth of knowledge capitalism.

Which of the following do you think are both likely and a concern for real asset investment?

Figure 10. **Likely and concerning events for real asset investment in next 12 months**



Source: Aviva Investors, May 2019

Interview with Daniel Blamont, Head of Investment Strategy, Phoenix Group & Sindhu Krishna, Investment Strategy Manager, Phoenix Group

DB: "Investing in commercial real estate and infrastructure debt continues to be challenging because there is a limited supply of opportunities that meet our criteria. Infrastructure debt in particular is a crowded market, with limited supply of matching adjustment-eligible opportunities meeting our spread targets.

We are still relatively early in our journey in the real assets arena relative to our annuity peers – we started in 2015 with equity-release mortgages, then in 2016 we moved into commercial real estate debt, and in 2017 we moved into infrastructure debt. We could be ramping up more quickly, but we don't want to overpay.

The obvious risk in real assets is illiquidity – if you suffer a downgrade or default you can be stuck with an investment that no longer suits. You should be able to find a buyer, but you may have to take a haircut and struggle to find a suitable replacement asset.

Trade wars are a concern to us to the extent that they disturb the macro backdrop and impact credit negatively. It could be a catalyst to the end of the credit cycle in the short term, but it is the longer-term fundamentals that matter to us as a long-term investor."

> *"Trade wars are a concern to us to the extent that they disturbs the macro backdrop and impact credit negatively."*
>
> **Daniel Blamont**
> Head of Investment Strategy, Phoenix Group

SK: "Given the long-term and physical nature of real assets, ESG integration is very important. It is not just about protecting against risks but also seeking opportunities with a positive impact. Real assets will increasingly play a crucial role in creating a low-carbon world to meet the terms of the Paris Agreement.

Given the amount of capital inflow required to transition to a sustainable economy, the question is whether there will be innovative and investable solutions for insurers.[o]"

> *"Real assets will increasingly play a crucial role in creating a low-carbon world to meet the terms of the Paris Agreement."*
>
> **Sindhu Krishna**
> Investment Strategy Manager, Phoenix Group

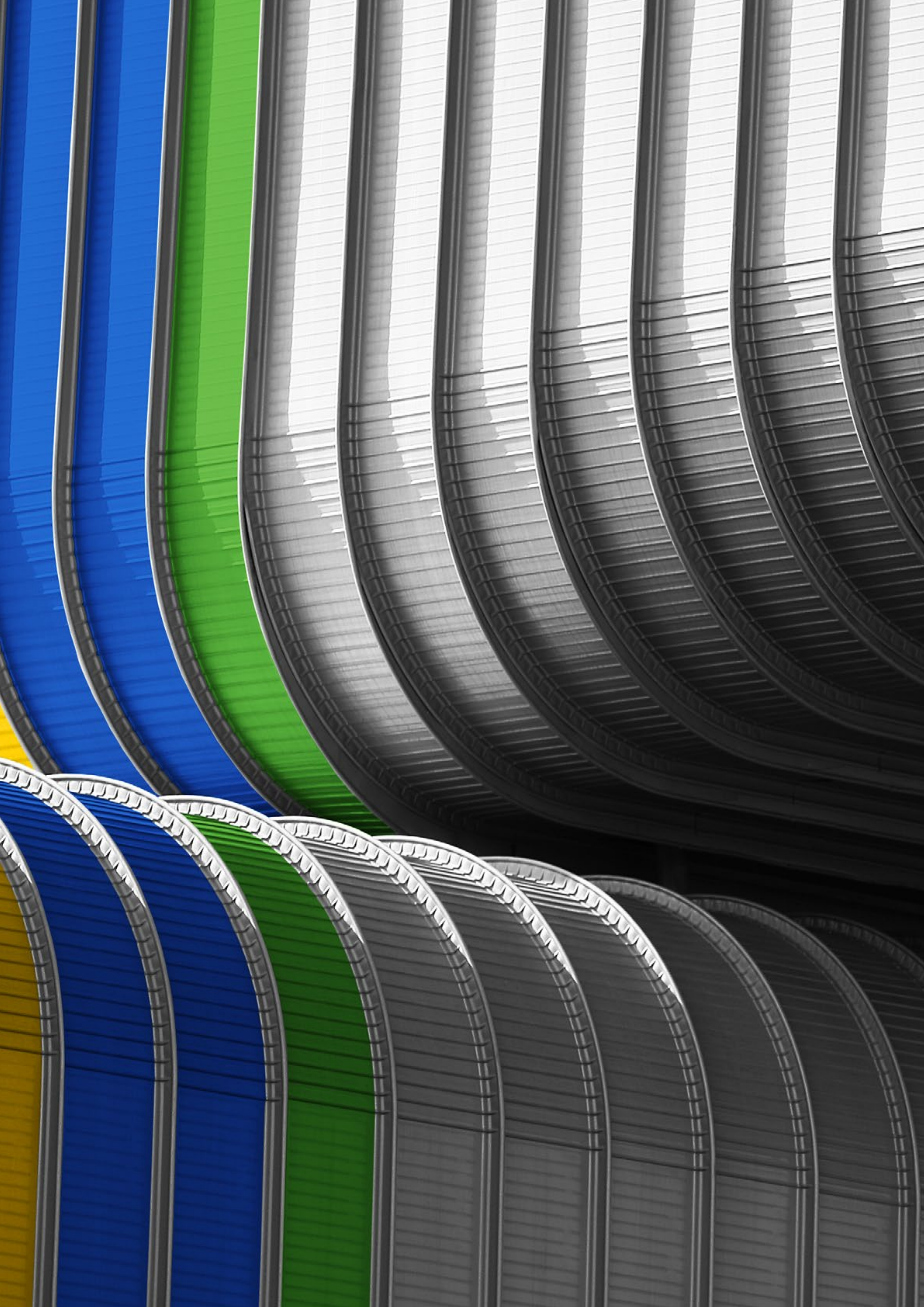
Key risks

Risks: Illiquidity

Real 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 assets 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.



Contact us at

Aviva Investors, St Helen’s,
1 Undershaft,
London EC3P 3DQ
+44 (0)20 7809 6000

www.avivainvestors.com

Important Information

Except where stated as otherwise, the source of all information is Aviva Investors Global Services Limited (AIGSL). As at 06 June 2019 Unless stated otherwise any views and opinions are those of Aviva Investors. They should not be viewed as indicating any guarantee of return from an investment managed by Aviva Investors nor as advice of any nature. Information contained herein has been obtained from sources believed to be reliable, but has not been independently verified by Aviva Investors and is not guaranteed to be accurate. Past performance is not a guide to the future. 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. Nothing in this material, including any references to specific securities, assets classes and financial markets is intended to or should be construed as advice or recommendations of any nature. This material is not a recommendation to sell or purchase any investment.

In the UK & Europe this material has been prepared and issued by AIGSL, registered in England No.1151805. Registered Office: St. Helen’s, 1 Undershaft, London, EC3P 3DQ. Authorised and regulated in the UK by the Financial Conduct Authority. In France, Aviva Investors France is a portfolio management company approved by the French Authority “Autorité des Marchés Financiers”, under n° GP 97-114, a limited liability company with Board of Directors and Supervisory Board, having a share capital of 17 793 700 euros, whose registered office is located at 14 rue Roquépine, 75008 Paris and registered in the Paris Company Register under n° 335 133 229. In Switzerland, this document is issued by Aviva Investors Schweiz GmbH, authorised by FINMA as a distributor of collective investment schemes.

In Singapore, this material is being circulated by way of an arrangement with Aviva Investors Asia Pte. Limited (AIAPL) for distribution to institutional investors only. Please note that AIAPL does not provide any independent research or analysis in the substance or preparation of this material. Recipients of this material are to contact AIAPL in respect of any matters arising from, or in connection with, this material. AIAPL, a company incorporated under the laws of Singapore with registration number 200813519W, holds a valid Capital Markets Services Licence to carry out fund management activities issued under the Securities and Futures Act (Singapore Statute Cap. 289) and Asian Exempt Financial Adviser for the purposes of the Financial Advisers Act (Singapore Statute Cap.110). Registered Office: 1Raffles Quay, #27-13 South Tower, Singapore 048583. In Australia, this material is being circulated by way of an arrangement with Aviva Investors Pacific Pty Ltd (AIPPL) for distribution to wholesale investors only. Please note that AIPPL does not provide any independent research or analysis in the substance or preparation of this material. Recipients of this material are to contact AIPPL in respect of any matters arising from, or in connection with, this material. AIPPL, a company incorporated under the laws of Australia with Australian Business No. 87 153 200 278 and Australian Company No. 153 200 278, holds an Australian Financial Services License (AFSL 411458) issued by the Australian Securities and Investments Commission. Business Address: Level 30, Collins Place, 35 Collins Street, Melbourne, Vic 3000, Australia.

The name “Aviva Investors” as used in this material refers to the global organization of affiliated asset management businesses operating under the Aviva Investors name. Each Aviva investors’ affiliate is a subsidiary of Aviva plc, a publicly- traded multi-national financial services company headquartered in the United Kingdom. Aviva Investors Canada, Inc. (“AIC”) is located in Toronto and is registered with the Ontario Securities Commission (“OSC”) as a Portfolio Manager, an Exempt Market Dealer, and a Commodity Trading Manager. Aviva Investors Americas LLC is a federally registered investment advisor with the U.S. Securities and Exchange Commission. Aviva Investors Americas is also a commodity trading advisor (“CTA”) and commodity pool operator (“CPO”) registered with the Commodity Futures Trading Commission (“CFTC”), and is a member of the National Futures Association (“NFA”). AIA’s Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to: Compliance Department, 225 West Wacker Drive, Suite 2250, Chicago, IL 60606

37316 - RA19/1356/21102020