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Illiquidity Premium

The Swedish Market
Liquidity Discount
The Relative Notion

Direct, or Indirect?

Active vs Passive
Meeting Client Needs
Debt Instruments

Real Estate & Infrastructure Investments

Topics Discussed:


Illiquidity Premia


Responsible Investing


Nordic Markets


Does Size Matter?

"Real estate is a very local asset class, and there are clear advantages and broad expertise to be gained by investing where you are located."

Editor´s Note:

As it so happens, I was fortunate enough to be able to listen into this round table. I found many things of interest. My greatest a-ha moment however was when Christer Franzén, of the Ericsson Pension Foundation, made a rather trivial observation: ***"People thought that real estate was an alternative asset. I had a hard time understanding why that was. Real estate in my mind, is probably one of the most basic ways to invest."***

And indeed, most of us can relate to investing in real estate, aspiring to own an apartment, a house, or even a farm to retire on. It often is the largest material investment we will make during our lifetime as private persons. Some may even accumulate enough wealth to make or contribute to a comfortable, work-free living generating income by renting out an apartment or agricultural land. It seems only natural then that also as an investment case, real assets such as real estate or infrastructure projects enjoy a certain popularity.

Reaching back through the ages, infrastructure projects were the vast, most time- and resource-consuming undertakings of mankind. Be it places of worship and religious ceremonies, such as the great pyramids of Gizah, Greek temples or the great European cathedrals, Stonehenge the Colosseum in Rome, the Moai statues on the Easter Islands, military and defensive installations, such as medival castles or the Great Wall of China...

With the steady growth of the real asset class in the past few years, assets under management are up, and yields are down. Asset managers and asset owners may sometimes find it hard to deploy capital, or to generate the return they need. Around a table in Stockholm on a cold January morning, HedgeNordic has assembled a group of seasoned real estate and infrastructure investors to discuss the critical points of real asset management and assess today's situation.

The discussion was vivid and touched many areas in a lively session. On the menu were the illiquidity premium, the question of size, the advantages (or disadvantages) of direct and indirect investments and also what Environment Social and Governance (ESG) factors are driving real estate and infrastructure projects.

There were some really interesting side pockets, too, to be discovered. In all, a much entertaining and informative session giving Nordic Insights from an unusually international group of experts which you can, through this paper, participate in.

We hope you enjoy reading these unique insights from leading experts.

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Aki Kostiander, CIO/Fund Manager and Managing Director UB Real Assets (MSc, Finance, Svenska Handelshögskolan, Helsinki/Vaasa), has over 20 years of professional experience from Investing and the asset management industry.

Aki has held many executive level and senior partner positions in different Asset Management organizations. He has besides many portfolio management duties been the managing director of two mutual fund companies and two asset management companies.

He has covered most types of asset classes during that time but the emphasis has been on global real assets and REITs for the last 12 years.

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Mikael Falck, is Head of Alternative Investments at Kåpan pensioner. He has extensive experience of the financial markets having worked with a wide range of responsibilities including portfolio management, asset allocation and corporate finance.

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Teresa Farmaki is the Co-Founder and Member of the Investment Committee of Astarte Capital Partners. Previously she was Head of Private Equity for Signia Wealth, a multi-family office. Prior to Signia, Teresa was CIO for Private Equity at Piraeus Group, where she co-led the establishment of the private equity group, launched three private equity and venture capital funds and developed the group's strategy in the renewable energy space. Teresa joined Piraeus from UBS Investment Bank in London and New York, where she advised on corporate transactions in the real assets space in the US and Europe. She Holds a BSc. in Economics and Finance from the University of Athens, Greece and an MBA from Columbia University in New York.

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Dirk is responsible for the global Private Capital: real estate, private equity, infrastructure and private debt business origination and business development within the Investor & Treasury Services division for Royal Bank of Canada.

Before taking this global role in early 2010, Dirk was Portfolio Manager at Pramerica Real Estate Investors Luxembourg. He has also worked in the Real Estate units at Commerzbank, Credit Suisse and Bankhaus Ellwanger & Geiger.

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Before joining Allianz Global Investors, Emmanuel was a Managing Director at BNP Paribas co-heading a debt advisory and financing team. He was responsible for origination and execution of advisory and arranging mandates across a broad range of sectors. Selected mandates include: advising Heathrow on the 3rd runway, advising Borealis in relation to the acquisitions and refinancings of Fortum Sweden (Ellevio) and Fortum Finland (Caruna), both power networks with a total value of ca EUR 8bn. Emmanuel has been involved in the infrastructure and energy sectors since 1997; prior to joining BNP Paribas, he was part of MBIA's public finance team led by Deborah Zurkow.

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Between 2007-2016, Jonas was a Senior Private Banker at SEB Family Office, within SEB Wealth Management. Prior to that, he held numerous positions within Svenska Handelsbanken between 1989-2007, leaving as Team Head of Asset Management/Private Banking. Jonas holds a bachelors degree in business administration from Uppsala university.

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MODERATED BY: ALINE REICHENBERG GUSTAFSSON, CFA - HEDGENORDIC

ROUND TABLE DISCUSSION

REAL ESTATE & INFRASTRUCTURE INVESTMENTS

With the steady growth of the real asset class in the past few years, assets under management are up, and yields are down. Asset managers and asset owners may sometimes find it hard to deploy capital, or to generate the return they need. Around a table in Stockholm on a cold January morning, HedgeNordic has assembled a group of seasoned real estate and infrastructure investors to discuss the critical points of real asset management and assess today's situation.

THE INTANGIBLE ILLIQUIDITY PREMIUM

The discussion starts with one of the most important but perhaps most intangible points in the domain of real estate and infrastructure investing: the illiquidity premium. In theory, investors should have a preference for being able to buy and sell assets quickly, and therefore illiquid assets should require a higher return – the illiquidity premium. Within the context of rock-bottom interest rates, however, the prices of real assets have soared in recent years. Where does that leave the illiquidity premium? Does it still exist? Can it be reliably estimated? Around the table, participants had quite a few opinions on the matter.

THE SWEDISH MARKET'S PREMIUM

Christer Franzén, Chief Investment Officer for Ericsson's Pension Foundation, gives an overview of the real estate landscape in Sweden and presents the context in which the illiquidity premium has been evolving recently. "Of course, the illiquidity premium has shrunk a little, but it depends on how you look at it," he comments. A few years ago, the premium was high because financing was difficult to obtain. "It was fascinating when we bought a property north of Gävle, here in Sweden, a two-hour drive from Stockholm, banks didn't want to participate so often, and that was just three years ago. We almost couldn't get a loan from the banks at the time, which was sort of good for us because we had a lot of money to deploy. Today, the spread between borrowing rates and the yield you get from properties are still high, but as with any asset, the total return can become too low on a risk-adjusted basis."


Aline Reichenberg Gustafsson - HedgeNordic

"I think that an illiquidity premium still exists, but it all depends on what one is trying to achieve. Currently, many people are chasing the same kind of investments." Franzén illustrates the situation with different yields that can be obtained in Sweden: "For instance, in a mid-sized Swedish town like Norrköping or Helsingborg, the yield used to be about five percent, on an on-need basis. Now the yield in Norrköping is down to approximately three and a half. In Stockholm, yields are the worst because investors have always been counting on capital gains." For projects, such as commercial parks, yields have in fact widened somewhat. "People are nervous about the housing situation in Sweden, which may have been boosted by over-speculation like in Norway, Canada, and Australia, but I believe that net-net, more investors are coming into the market because there is so much money to be deployed. We see many large foreign investment firms starting to compete for assets. " For Franzén, there is a right balance in several areas, but to some extent, the availability of capital still makes for a seller's market.

A BROADER EUROPEAN PERSPECTIVE

Dirk Holz, Head of Origination and Business Development, Private Capital Services at RBC Investor & Treasury Services, has a birds-eye view on the whole market, as he can see what his clients are doing in different parts of the real asset spectrum. "When it comes to direct investments," he comments, "we can see that institutional investors have significantly shifted from more liquid asset classes towards private capital strategies." Holz is also able to quantify some of the effects of the demand shifts generated by the low-interest environment. "If you look, for example, at the established UK market, properties' average yields in the past years were between 3.5 and 6 percent. Currently, the yields have come down to around 2.5 to 3.5 percent. For some trophy properties, the yield can be as low as 2 percent. With such a high level of yield compression, the premium was squeezed heavily compared to the interest rates. That is something we believe will continue or at least will stabilise at the current level because we see more and more institutional investors very keen to invest in long-term real assets."

Holz believes it is key to contemplate the difference in shifts between purchase yield and investment IRR. "In many cases, we still see IRR expectations in the range of 10 to 15 percent, which is quite ambitious. Meanwhile, these investors are pitching for properties in the range of 2.5 to 3 percent purchase yield. They are looking to generate the rest of the return out of the future value increase. It is key to understand from which area the premium will be coming from. On the buying side at the moment, the premium has shrunk substantially." Despite these challenges, there are several reasons Holz believes institutions are and will stay in the real asset space, in particular, the natural asset-liability duration matching institutions are looking for. "In real estate and infrastructure, you have a natural hedge. You have a very long-term cash flow normally out of the rental income or infrastructure project."

THE RELATIVE NOTION OF ILLIQUIDITY

For Teresa Farmaki, Founding Partner at Astarte Capital Partners, evaluating an illiquidity premium is difficult when there are no directly comparable liquid options. She gives us a concrete example: "If we look at deploying capital in dry-bulk shipping, what could be comparable on the liquid side? We could find listed shipping companies, but they are not pure-plays, and they often have many other aspects that would make them inadequate comparables." However, Farmaki believes that there is a significant premium to be harvested in the areas she invests in. "There is a premium if you want to call it that, for investing privately or directly into these illiquid assets because accessing these opportunities is difficult. We may also encounter legacy aspects such as existing debt or commingled assets that alter the return profile of a particular investment. In the types of situations we typically look at, we still often target returns of about 15 to 20 percent, which we generally wouldn't be able to find in liquid markets."


Dirk Holz, RBC Investor & Treasury Services

THE COMPLEXITY PREMIUM

Emmanuel Deblanc, Head of Resilient Credit Strategy at Allianz Global Investors, agrees with Farmaki. For him, the premium for real assets may come from the complexity, rather than the illiquidity inherent to particular investment opportunities. "What does the illiquidity premium represent? Our experience has been that bad assets are illiquid. In our experience, the good assets are quite liquid, even in tough markets. We would like to call such premium "illiquidity and complexity premium". The fact is that those assets are not necessarily getting an illiquidity premium because they are illiquid, but more because they are hard to originate and to structure. These opportunities take time, and an entire team needs to be involved. Therefore, the premium pays for the hard work."

Interestingly, Deblanc believes this premium is quantifiable to a certain extent. "The biggest surprise we have observed," he continues, "is that returns have compressed in aggregate - valuations have increased across infrastructure, debt, or equity, and obviously other asset classes - but the illiquidity/complexity premium has remained relatively constant. This is interesting because as a share of the total return, the premium has actually increased." This phenomenon may be counter-intuitive. Deblanc and his team initially believed that all components of investment return would come under pressure at the same time. Instead, this premium has become a larger share of the return in a low interest-rate environment, at least in Deblanc's books. There may be two different explanations; he believes: "There is the fixed cost of resources, and the public markets have compressed so much, especially on the credit side that if you hold onto some rigour, you can increase the contribution to total returns."

Farmaki jumps in to support Deblanc's point: "I could not agree more with Emmanuel," she says. "We call this premium 'operational value added'. The operational complexity is something that we believe is the core of generating returns going forward, and the reason for going private. We believe that a premium exists because there is an opportunity to add value, difficulty in sourcing, and in improving the asset. An example could be growing a business, or it could be refurbishing an asset. There will always be a return in that opportunity that does not depend on market return."

> "The fact is that those assets are not necessarily getting an illiquidity premium because they are illiquid, but more because they are hard to originate and to structure."
>
> *Emmanuel Deblanc*

Then Farmaki aims at quantifying this complexity premium. "Even if we typically look primarily at equity interests, we can go into more structured credit situations, and there we estimate at approximately two percent the cost of adjusting for complexity. If a team can react quicker than other teams, in providing private debt or structure with a debt solution in more complex situations, it can typically generate a couple of additional percentage points on the total return. This is especially true when returns are squeezed overall." For Deblanc, the size of the premium is similar, albeit slightly below Farmaki's estimate. "We observe between 100 and 150 basis points, perhaps in a part of the credit space that is already slightly tighter, given that the infrastructure space is typically a more stable part of the asset class." Farmaki specifies that her estimate refers to a particular market where deals are somewhat smaller, around US$25 to 50 million. In these segments, the number of participants is lower.

Another observation Deblanc makes is that markets in the US and Europe exhibit different characteristics. "We can obtain a higher illiquidity premium in Europe than in the US," he explains. "The reason is that capital markets and access to private debt are much more developed in the US. There's a big gap. Roughly speaking I think we have about 40 percent less of an illiquidity premium in the United States where there are many more actors. The universe is broader there, perhaps because it is more mature."

THE LIQUIDITY DISCOUNT

Defending a diametrically opposite view, Aki Kostiander, Chief Investment Officer for United Bankers' Real Assets division, believes that having a premium for illiquid assets may not be as evident as it seems. More specifically, he exposes the paradox of the opposite; "liquidity discount" in the REITs market. "If you look at the listed markets that I've been working with for quite a long time, it is interesting to observe the opposite of a premium. The liquid REIT market can trade at a discount. You can see that even in markets that are highly efficient like New York. You can have a REIT in New York that holds a big high-quality property portfolio in Manhattan, and it has fallen to a 20 percent discount. At the same time, you have private equity funds buying Manhattan properties on the net asset value. At the moment this is made possible by headwinds on the liquid listed markets because of the rising interest rates. The tail is wagging the dog to some extent."

The "liquidity discount" may be even more pronounced in the UK, given the uncertainties generated by Brexit. "There's 25, 30 percent discount on many listed property companies," adds Kostiander. "Big British REITs at the moment exhibit huge discounts. It doesn't make sense to buy London or UK property directly. It is cheaper buying a listed portfolio." On the debt side, and more specifically for infrastructure projects, Kostiander concedes that the illiquidity premium can be warranted, and easier to define. "When investing in a toll road for example, then, of course, you need a higher yield because you're stuck with the investment for decades. When the durations are very long, you need a premium."

HARVESTING ILLIQUIDITY FOR A LONG-TERM INVESTOR

Coming from the allocation side, both Mikael Falck, Head of Alternative Investments at Swedish pension manager Kåpan, and Jonas Andersson, Chief Investment Officer at Stockholm-based single-family office Navare Invest, firmly believe that an illiquidity premium exists, even if it is difficult to measure. "I agree with many of the other panellists that it is hard to put your finger on the illiquidity premium," says Falck. "It is hard to define and measure. I think that an illiquidity premium might be different things for different investors." One point often associated with illiquidity is that it reduces volatility. But, Falck argues, neither is relevant for a long-term institutional investor. "We can hold on to the assets to maturity, which means that liquidity itself becomes less relevant. Volatility, I might argue, is more of a technicality, as there isn't the mark-to-market effect associated with listed assets."

The long-term horizon is all the more relevant for Family Offices, as Andersson illustrates: "I am also a firm believer in harvesting the illiquidity premium, especially since our

> "We call this premium 'operational value added'. The operational complexity is something that we believe is the core of generating returns going forward, and the reason for going private."
>
> *Teresa Farmaki*

investment horizon spans at least over three generations. We are not in a hurry. If someone can provide a good risk-adjusted return, and not only a good IRR, but preferably a cash flow, I wouldn't mind committing to an investment for 25 years." While the overall returns on real assets might have fallen, Andersson acknowledges, due to the banks' willingness to lend and the ensuing increase in competition on the real asset market, "the relative margin on the illiquidity premium has increased in this low or negative interest rate environment. It is still relevant to look for longer-dated commitments."

Franzén elaborates on this point and stresses the notion that increasing spreads between real asset yields and interest rates can easily make investments more attractive. "When we started investing in real estate in 2009, if you bought something for an unleveraged yield of five percent, and you went to a bank you could perhaps borrow at four and a half. You got six percent total return thanks to the leverage. Today, when you have the same unleveraged deal, and the bank may ask for a little over one percent, you obtain private equity returns. The spreads between the borrowing interest rates and the yield you can buy assets for, is historically high, even if that yield decreased."

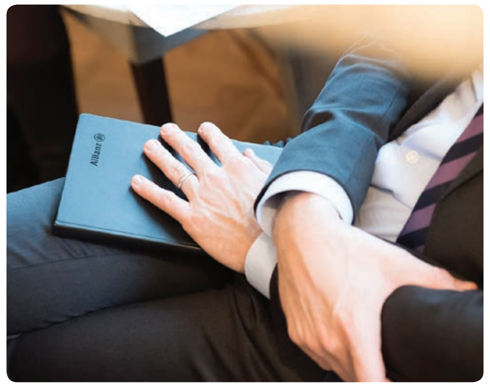
ILLIQUIDITY MEANS LOW VOLATILITY

For Kostiander, volatility is an essential element in explaining the illiquidity premium, or in the case of REITs, the liquidity discount. "I think that one of the biggest issues comes from capital requirement ratios. In the context of Basel III rules, negative interest rates in Germany, amongst other points, leads investors to buying illiquid cash flow investments, such as prime properties in London, or Frankfurt. The yield and cash flows attract investors to property, as they help immunise against inflation. It makes sense. That explains why the total return on many of these prime illiquid assets has dropped to a level which perhaps is not sustainable over the long term. And most of these investors hate volatility. They can't tolerate it. This is why there is a free lunch, wherever you can buy REITs with a significant discount, containing e.g. the finest real assets in New York or London."

Falck admits that liquid structures might offer benefits to some investors, providing liquidity to inherently illiquid asset classes like infrastructure or real estate. "We don't need the liquidity in our alternative investments," he says, "however, I can see the benefits this offers for some investors. If we had stricter allocation targets for underlying asset classes, liquidity could be fairly valuable in trying to reach allocation targets in the short term."

ARBITRAGE OPPORTUNITIES BETWEEN LIQUID AND ILLIQUID VEHICLES

Franzén also stresses that keeping an eye on the differences in valuations between the liquid and the illiquid parts of the asset class can generate opportunities. "In 2009 listed real estate companies here in Sweden traded at a



30 percent discount. That changed over time. Five years later, they traded at a 30 percent premium, a 60-percentage points difference. A real estate investor should have an eye on the listed real estates because there may be an opportunity-driven trade. You don't necessarily have to think about it as an equity trade but instead, think that you are buying properties at a discount and selling at a premium. In this case, several IPOs took place one or two years ago, and the public bought assets through the listed vehicles at very high prices."

Kostiander shares additional points on the advantages and disadvantages of listed vehicles, and stresses the pitfalls of mark to market, especially for open-ended vehicles. "There are two different vehicles that you may call liquid. A REIT, typically, or infrastructure company, is a listed stock that is liquid. There are also open-ended funds that can be called liquid on the private equity side. The there are of course quite illiquid closed end funds. On the open-ended fund side, there is an inherent problem, due to the necessity to mark-to-market." For listed companies, the market price

> "It is hard to define and measure. I think that an illiquidity premium might be different things for different investors."
> *Mikael Falck*

will reflect the market's discount or premium on the market valuations that are published by the company. In open-ended funds, investors have the opportunity to subscribe or redeem fund units, and hence, time-lag may be an issue. "You could see for example," says Kostiander, "that German open-ended property funds were in trouble during the financial crisis. Many of them had to close down, some of them permanently. You could see the same dynamic in the UK through the Brexit as well. When it happened, some open-ended funds temporarily closed, but they eventually opened up again. For some investors, it is challenging to realise that they buy illiquid assets they can redeem, but only under normal circumstances. It is not always easy for fund companies to calculate the fund's value when the market is distressed. Property evaluators, the specialists who value the portfolio properties, usually third parties, are quite conservative, and they are reluctant to change the valuation much. They are a slow-moving train, while markets can move quite fast." For Kostiander, open-ended funds are where there is a problem, if the investment is not done with similar criteria and within the same trime frame as with closed end investments. This issue is not so important with listed closed-end vehicles such as REITs, where the mark-to-market delays are captured by the discount or premium the stock trades at, compared to the published NAV. "As I mentioned, some REITs in e.g. London and Manhattan are trading at a big discount," he illustrates. "You can also have an opposite situation, such as last-mile logistics REITs that are considered the hottest of the hottest. These listed last-mile logistics stocks can trade at a premium of 20, even up to 40 percent."

DOES SIZE MATTER?

As with liquidity, not everyone agrees on the question of investment and investor size in the context of real estate and infrastructure. Is bigger better? Or does size hinder an investor's ability to participate in some of the most exciting opportunities?

BIGGER IS BETTER

Deblanc, who works for the manager of the largest portfolio of infrastructure debt in the world at Allianz Global Investors believes size gives his platform an advantage. "We are the largest," he says with a smile, "and not by a few million. We try therefore to find situations where we are capturing a value that comes with that size. We find ourselves in unique situations where we have practically no competition. We are the only investors involved in acquisitions and M&A processes, who have the resources and the willingness to do the work upstream. I am not simply saying that there is value in just being very big. Size gives us the opportunity to move upstream in the processes, and we can shape the product to fit out needs. We can influence what comes out of a process and impose our requirements. We can interact at the onset of a process instead of being at the receiving end of a packaged deal."

As a result, the negotiation is not only focused on price, which is the parameter most investors face, when presented with a pre-arranged deal. "We focus on generating a deal that protects our downside," Deblanc continues. "That's a key principle. In credit when you look at a vehicle that has ten investments, if you lose money on just a single asset, your returns suffer. It is very different in a private equity story where you can afford to lose on one investment, and outperformers counterbalance that loss." In the credit space, the upside is capped, and therefore one losing position can easily erode the rest of the portfolio's performance. "From our perspective," concludes Deblanc, "we have to ensure that we protect our downside, and size allows us to structure a product that we think is money good. That is how we benefit from being the largest player."


Emmanuel Deblanc, Allianz GI

Holz agrees with Deblanc. "I believe size does matters in this asset class," he starts. "Looking at infrastructure, in particular, we observe that the top 20 global firms are raising 50 percent of the global money allocated to this asset class. There are several ways we can explain this. The first reason is related to what Emmanuel said on the debt structure. Even when running such investments directly, it is a high-touch business. You need people and expertise. It is very management intensive. If you invest globally, it is also important to have local teams, and you need a minimum size to manage global portfolios and investments which presumes a decent size."

For Holz, investment ticket size is also a reason to consider. "The big successful managers can go for larger investments that their smaller counterparts can't access. They are able to purchase larger portfolios and restructure them." On the other hand, niche players will always have a space in the industry. "There will always be a space for smaller firms to be specialised on jurisdictions and strategies, within real estate and infrastructure, giving them the edge on being more focused on individual client needs."

SIZE CAN ALSO BE A HANDICAP

Jumping in at this point, Farmaki whose firm, Astarte, targets US$ 500 million assets in 2018, firmly believes that size, to the contrary, can be a disadvantage. "We have a very different experience," she says. "In today's world, where you have so much dry powder from many mega funds, it is so difficult to deploy capital that you can destroy yields and returns. Size can play against you if you're a buyer. Buyers should prefer smaller assets. Sellers prefer larger assets because there is strong competition to buy big-ticket assets. A well-known alternatives consultant recently shared that some of their larger pension clients have even invested in almost zero yield under pressure to deploy capital. At the high-end, the transactions and the assets are so few that the competition becomes significant."

Nowadays, Farmaki finds more opportunities for adequately priced assets in medium-size transactions. She concedes that there are limits on the downside as well: "Obviously, investments cannot be too small because costs don't scale down. Transaction costs and expenses are the same whether you're buying a US$ 10 million asset, or a US$ 1 billion asset. Perhaps I am exaggerating a little, but there certainly is a minimum to fixed costs that a transaction has to sustain."

"In mid-market opportunities," Farmaki continues, "there is just less competition, due partly to informational asymmetry. It is a market that depends much on one's local network, one's ability to find the right assets, and to negotiate the deal, as opposed to transactions proposed by intermediaries, brokers, etc. The larger the transaction, the more visible it is. In mid-market transactions, you can still find assets that are more negotiated than in outside processes. You may want to stay away from those larger deals."

A FINNISH EXAMPLE

Kostiander agrees that the necessity to achieve sizeable deals generates price pressure upwards. "In a small market like Finland for instance, ten years ago, when a large investor was looking at buying a property portfolio, there could be a discount. It was assumed that there were some mediocre and problem properties embedded in the portfolio, so they didn't want to pay the full price. Today, we see the opposite; portfolios sell at a premium. International investors, especially large ones are ready to pay more for size-

Direct or Indirect Investments?

Mikael Falck

"Fund commitments require manager selecti on skills, whereas co-investments require single deal due diligence skills and the ability to execute deals quickly."

Teresa Farmaki

"People tend to underestimate the resources needed to monitor direct investments properly."

Investing Sustainably in Real Assets

Christer Franzén

"The trend is that environmentally-friendly buildings attract tenants. (...) This is a perfect way to contribute to improving the environment, building better houses or refurbishing older ones to reach a higher environmental standard".

Jonas Andersson

"I am a firm believer in sustainable investing and ESG principles, but from a purely capitalistic point of view, because I think that it will be profitable in the long run."

Does Size Matter?

Dirk Holz

"Looking at infrastructure, in particular, we observe that the top 20 global firms are raising 50 percent of the global money allocated to this asset class."

Aki Kostiander

"It is as if size has become a handicap for funds when they are too big."

Emmanuel Deblanc

"Size can provide this advantage, the ability to shift slightly when a market is not generating the expected returns"

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able portfolios. It is as if size has become a handicap for funds when they are too big."

Kostiander highlights the advantage of REITs in this context. "Those large funds have to deploy the cash to buy the assets, and that is another big difference between listed REITs and private equity funds. Private equity is a business. The manager has to deploy the money eventually. He has to buy even when the market is hot, which means buying at steep prices. There is empirical evidence on that. A REIT is a going concern, and it doesn't have a maturity or exit. This allows the manager to be patient to buy when assets are cheap."

> "... the top 20 global firms are raising 50 percent of the global money allocated to this asset class."
>
> *Dirk Holz*

As an example, Kostiander proposes Sponda, a Finnish listed company that was bought out by Blackstone in the spring of 2017. "They paid a nice price," he remembers. "These big investors can buy out cheap REITs like e.g. the Manhattan one I mentioned earlier, but it may also go the other way around sometimes. Before the 2007 financial crisis, the largest REIT in the world called Equity Office Properties Trust was taken private, right at the top of the market, and it was a disaster. Perhaps Blackstone had bought the company because of the pressure to execute and put the money to work? With today's low yields, there is not much cushion, especially in prime properties. In Stockholm for instance, prime yields are very low today."

Kostiander contrasts the agenda of funds with that of large institutional investors, which face another kind of pressure. "The life insurances companies and some pension funds have to allocate according to the maturity of their liabilities, and they would rather buy a three percent yielding core property in Germany instead of German bonds with negative yields. A property investment has an inflation hedge as the rents are indexed upwards with inflation. Quantitative easing has twisted the game as you have negative real rales in many traditional bon investments. REITs can, today, exhibit large discounts because investors are afraid of the end of QE programs that support prime property yields. Even though interest rates can go up, and quite a lot of investors are worried about it, they have to invest as there are few solid alternatives to get real returns. So, on the other hand, they are worried, but the left hand is buying property all in. There is so much money around which needs to be deployed! The big investors have a lot of that money, and they have to satisfy the end-client."

AN ELEPHANT CANNOT PLAY IN A CHINA SHOP

Franzén agrees that size plays an important role coming from both ends. "If you belong to the Calpers of this world," he says. "what can you do? You need big tickets to deploy your capital. If you are a smaller entity you may have a choice. You can go with specialised funds, and you can find properties of value, for which competition is less strong. For smaller players placing money with large funds will probably generate less return compared to what one can achieve directly, or with a smaller manager."

Holz elaborates on the idea that institutions typically look at funds in their own league. "Investors who need to deploy 10, 20 or 30 billion typically would not choose a specialised provider which is asking for smaller ticket sizes in the range of 10 to 50 million. This is at the heart of the problem: investors have to work hard. There is massive dry powder available and additional money coming in that has a huge impact on the pricing. In fact, we are seeing a change in the pricing model. This is a global trend."

REACHING THE GOLDILOCKS SIZE: NOT TOO BIG, NOT TOO SMALL

Falck introduces the idea that there might be an ideal size, which is not at either end of the spectrum: "Of course size matters. All else equal, one would think that bigger is more beautiful. The obvious reason for that is that bigger fund commitments are usually associated with fee reductions. With larger amounts of capital, you can start co-investing, lowering your average investment fees. If the organisation is big enough, you can even start your own direct investment program. However, as illustrated earlier, there are also challenges in becoming too big of an investor. There might be an optimal size even from an insti tuti onal investor's point of view."

AGILITY MUST COME WITH SIZE

Deblanc points out that a redeeming quality for large asset managers may be its ability to be nimble within its mandate. "A manager should have the ability to redeploy resources on different segments with the same skill set and the same type of clients, to seek relative value somewhere else when a particular market segment is getting heated. Size can provide this advantage, the ability to shift slightly when a market is not generating the expected returns."

Sharing some of his personal experience with this team, Deblanc adds: "When the market has matured, for example, you need to develop a strategy that benefits from size. Becoming a pioneer in some markets may be one answer. In due course, everybody may join in, but while your first-mover advantage lasts, you can generate a lot of value. It's an ever-ongoing chase of rotation."

Franzén echoes Deblanc's previous point, where he suggests that size gives his team the opportunity to design a deal. "Regardless of size, whether or not you own your assets or lend money directly, you should actually drive the business. You should be in the driver's seat. If you are not, say that you are investor number five, for example, don't do it."

INVESTMENT PHILOSOPHY CHANGES WITH SIZE

For Kostiander, size also influences the investment philosophy. "The larger an investor, especially on the property market, the more top-down oriented the strategy. The smaller the investor, the higher the ability to add value, or to capture an opportunity. Therefore, the investment philosophy differs. In the example of the listed property company Sponda, the company was taken out of the market at the time the Finnish economy had just turned around. I was buying Sponda, but the large fund bought the whole company just because of how they saw the Finnish economy, and because it was a Euro asset. It was a great top down topic, and they made a nice investment in my opinion. I was sorry to see the company disappear, but of course, it benefitted from the transaction. The buyer had the size and a top-down view, and they could just execute it. It goes both ways."

A SMALL FISH IN A BIG POND

Andersson gives his perspective on size, given the smaller size of his firm, compared to the larger institutional peers present at the table. "Everyone knows that infrastructure and real estate are dealt in higher ticket sizes because €100,000 doesn't give access to interesting property deals. What we try to do is cooperate and co-invest together with others we know well. We try to be, if not in the driver's seat, at least in the passenger's seat and not in the trunk. We seek to have at least some control. We also invest through smaller fund structures to get access to this asset class, precisely because it often requires a large amount of capital."

Christer Framzén, Ericsson

To give us an example that ties in both size and liquidity, Andersson continues: "We have done direct investments in forestry in the Baltics. Through a management team, we do the groundwork and buy small plots of forestry land in that region at quite a heavy discount. Then, when we reach a certain area threshold, all of a sudden, we can flip it to an institutional player at a very decent premium. Hence, we capture the illiquidity premium. We commit our money for four years, but we don't mind because we can buy something at a discount and sell it at a premium just by adding size. There is indeed an interesting dynamic in both the size and the illiquidity dimensions of this asset class."

DIRECT OR INDIRECT INVESTMENTS?

A COMBINATION OF BOTH

Transitioning into the topic of the advantages of direct and indirect investors, Andersson believes a combination of both is necessary, especially for smaller investors. "We have done both types of investments. When we get the opportunity to invest directly, of course, we like to do it, given that we can retain control. Cutting out the fee layer is also a motivation. If we do the work ourselves, even if we set up an external management team to run the investment operations, we can still obtain a better IRR and better control over exit points. On the other hand, for some assets, such as those Emmanuel mentioned, the deals are complex, so we couldn't do them on our own. Even a bigger pension fund wouldn't be able to do them because they lack the knowledge or the access to those deals. You may also find a truly skilled manager. Those are the reasons to invest in an externally managed vehicle. We do both, and we see value in both. When we look at buying property just for the cash flow, we prefer to make a direct investment whenever we can. Where we want the added alpha, that's where we try to go with a skilled manager."

MEETING THE NEEDS OF MID-SIZE INVESTORS

Farmaki agrees with Andersson, and she can contrast different approaches, having had experience investing on behalf of individual investors, as well as managing closed-end funds, in a typical private-equity setting, and now, as manager of a co-investment platform. "It depends on how much you know and how big you are. If you know what you are doing, you are better off going directly, keeping controlling interests. If you don't know what you are doing, you are better off investing with someone who does. Meanwhile, the size is also important because it affects access and deal flow. Investing directly requires a certain quality in deal flow. If you are not very well-connected in the area that you are looking to invest in, or you are not large enough to be on the top of the list of people to approach, you have a big risk of ending up in a lemons market. You may not get the first call on the best deals, and that is the last thing you want. Different opportunities require different approaches."

To meet the needs of mid-sized institutional investors, Farmaki and her team set up Astarte. "At the moment, you can see a clear bifurcation of investors. The very large ones tend to develop dedicated platforms and invest directly on their own. It makes sense. Why wouldn't they? The very small ones, by default, have to commit capital to commingled funds. They don't have enough leverage to demand terms or play active roles. Most probably, they don't have enough expertise to have a diversified allocation or a proper program. The mid-size investors or mid-size pension funds that we work with are sophisticated enough and large enough, to be able to have a view of where they want to invest. At the same time, they are not large enough to

support the cost of having their own dedicated platform. We believe that the opportunity lies where we can bring sophisticated investors and silent investors together. They can both access better opportunities in a better way at a reasonable the cost. Cost is indeed often a big discussion."

> "Looking ahead, co-investments and club deals will continue to be relevant. It helps address the size problem also for smaller players when they can find similar-minded investors and make it happen."
>
> *Aki Kostiander*

Falck shares his experience from the perspective of a medium-sized Swedish institutional investor. "I think that many investors would like to have a large proportion in direct investments for the obvious reason of fee reductions. However, because of the points Teresa and Jonas mentioned, they aren't able to. From our point of view, the only place we prefer to invest directly, or as close as possible without technically being directly invested, is in Swedish real estate. In some cases, we have, together with an asset manager, identified an interesting portfolio, and structured a company around it. We either go at it alone, or set up a club-deal structure with likeminded investors. We always hire a manager to take care of the asset management. When investing in alternative investments outside of Sweden, we go through fund structures. I would like to co-invest and stay as close as possible to investing directly, also outside of Sweden, but with limited resources, it is not optimal. When moving away from fund investing, the administrative burden grows fairly quickly."

Farmaki weighs in with her experience in co-investment structures. "Everybody asks for co-investment rights with investment. People tend to underestimate the resources needed to monitor direct investments properly. It is not enough to invest and feel good about not paying the fees. Monitoring requires resources."

Falck also highlights that the required due diligence skills are different when evaluating funds and co-investment opportunities: "The due diligence when committing to a fund differs from that of doing a co-investment. Fund commitments require manager selection skills, whereas co-investments require single deal due diligence skills and the ability to execute on deals quickly."

Farmaki agrees and illustrates the point: "Some investors in our typical strategies come to us, asking help to evaluate their co-investments because they have so many of them. They just cannot handle these investments, partly because the response time is usually six to eight weeks. They don't have three months or nine months to perform a due diligence process. They ask us to help them evaluate their co-investments portfolio, and they require an alignment of interest. They want more than a monthly review of their co-investment opportunities. They want to have an honest opinion if the opportunity is good or not. This is a service we are developing now."

ACTIVE VERSUS PASSIVE INVESTMENTS

For Holz, direct versus indirect investing translates into active versus passive investing. "If you are an active investor it means you can influence the value. You can create value by touching the asset, infrastructure or property, whatever it is. In the portfolios we administer, the proportions are roughly 80/20 of active versus passive allocation. Many investors want to be involved, not always in the driver's seat, but be close to the decision-making process. Which investment do they make? What is the strategy of the investment? Property is a good example. Investors can create value by putting long-term lease contracts in place for example or by upgrading a property to a higher standard. Even with marketing, it is possible to add value to real assets. This is one of the interesting parts of investing in real estate and infrastructure. Many players love it. On the other hand, it requires knowledge, expertise, people, and a lot of time. This may be the reason why we see investors preferring the passive route."

DEBT: DIRECT INVESTMENT IN AN INDIRECT WAY

Tying in the debt side of the asset class, Holz continues: "Institutional investors are interested in debt strategies because indirectly they have access to either infrastructure or real estate assets. As lenders, they don't have to run and manage the investment. It makes things easier for them, and it is an interesting way to convert more liquid asset allocations to alternative, without having the same workload as with direct investments."

Kostiander agrees that debt provides interesting access to the asset class, also for other reasons. "Some pension investors would rather have debt structures in place just because of their capital requirements. Equity investments require more reserve capital than bond investments, corporate credits, credit structures or even debt investments in properties."

EVERYONE WANTS TO FREERIDE

On the topic of co-investments, Kostiander gives some recent examples where it made sense even for a large foreign investor to join a local player. "Citycon, which is a listed Nordic player specialised in shopping malls, owns e.g. Kista Galleria, a shopping mall just outside of Stockholm, together with the Canada Pension Plan Investment Board. There is also a mall in Finland that they owned along with the Singapore Sovereign Wealth Fund. When Singapore exited, Citycon bought their share. It is not unusual even for larger investors to try and free ride. It makes sense when one local firm manages the investment, and the larger investor sends a check for the practical management of the asset. Looking ahead, co-investments and club deals will continue to be relevant. It helps address the size problem also for smaller players when they can find similar-minded investors and make it happen. Somebody has to do the work, and usually, it pays to pay. You pay peanuts; you get monkeys. For the sake of management quality and peace of mind, sacrificing some of the upside may be warranted."

CO-INVESTING HELPS WITH DIVERSIFICATION AND SCALE

Another reason for co-investing goes back to the idea of size for Andersson. "Sometimes, we realise that we cannot invest in smaller assets because we don't reach the threshold where we can hire a manager for the property. As Mikael said earlier, I don't have time to run around and change light bulbs in the house and hand out invoices for the rent. We have to reach a scale where we can hire someone to run the properties and run them more professionally. That is one of the reasons why we try to group assets under one structure, alone or together with other investors. We can also diversify our portfolio since we can hold a third of the cake in 10 different property portfolios, for instance, instead of buying two large chunks in one. Both risk allocation and scale are good reasons for co-investing."

Mikael Falck, Kåpan Pension

INVESTING SUSTAINABLY IN REAL ASSETS

It is interesting to look at the idea of control and relate it to the theme of Environment Social and Governance (ESG) factors. What kind of requirements do investors around the table face as owners or as an asset manager? What is the demand of end-investors? What are the trends in ESG?

A LACK OF STANDARDISED NORMS AND A CHANGING WORLD

Kostiander starts by pointing out that the lack of a level playing field in the matter of ethical investing makes it very difficult to evaluate especially in infrastructure. "It is important to recognise that the world changes. Something that we feel is okay today can change down the road. Vattenfall's investment in German coal energy in 2001 is a good example. It was a decent investment at the time. Then years down the road, that's a no-no. The world changes around you. Another typical challenge when looking at infrastructure is the fact that you might make a great investment today, checking all ethical standards, a good IRR, etc., but people change as well. Which one of you has been working in the same job for 20 years? Infrastructure projects have a very long life, and ESG is evolving fast today. Other people will be those evaluating and managing the initial investment in the future. It is very tricky to make a hard-cut decision that we will exclude some projects, where you may have to backtrack after a few years."

Falck agrees with Kostiander. "Kåpan has a high focus on ESG investing. It is an important issue for us. We incorporate ESG factors as much as possible into our investment processes. One of the big issues is what Aki was referring to, that there are no real standardised norms of what is ethical and what isn't. Lines can sometimes become blurred, which makes it more challenging for investors."

PROPERTIES ARE A GREAT PLACE TO START

Franzén argues that being able to shape assets can have a direct influence on the environment. "If you own your own properties, you can work with them. We have a classification system for real estate in Sweden. There is a way to measure how environmentally friendly a property is. Tenants who are becoming more interested in higher-ranked properties. The trend is that environmentally-friendly buildings attract tenants. This allows us to go hand in hand with their interests. This is a perfect way to contribute to improving the environment, building better houses or refurbishing older ones to reach a higher environmental standard."

Falck agrees that concrete measures and actions can make an investors' sustainability efforts easier to integrate. "You can work on concrete ESG solutions with real estate assets and, as an example, an infrastructure manager can effectively implement environmental-friendly solutions within renewable energy investing."

NOT EVERYONE IS A SPECIALIST IN EVERYTHING

A few years ago, Deblanc and his team didn't think that ESG was going to be as significant as it has become. "ESG is prevalent in pretty much everything we do right now, whether it is investing or behaving, which is a good thing. However, there are some drawbacks and being in a big institution means that we have dedicated people who we can talk to because we can't be specialists in everything." To illustrate his point, Deblanc talks about flexible power generation in the UK. "There are some diesel engines, or gas-fired engines, which, you may think, are not great for the environment. However, those flexible generators are small to medium-size providers of electricity in the system, and they are necessary for renewable energy to come on stream. Renewable energy cannot exist on its own if you switch off all coal-fired and nuclear-fired plants. Renewables don't solve the whole equation. As it happens, the sun doesn't shine all the time in the UK! We actually discussed the issue with ESG specialists. They found that the contribution regarding pollution of these fossil-fuel engines in only marginal. Hence, net-net, they are necessary. We value the fact that we have got experts and people who actually can judge the issues having a much more well-rounded, and a much deeper understanding of what these ESG issues are. It is getting quite tricky, and it is still a developing, maturing field."

Franzén stresses Deblanc's point and gives some historical perspective. "Ten years ago, when we started the ESG proposal was very square. It was mostly about blacklisting companies that did something you didn't like, given your ESG data. Today it has developed a lot. People are more

Teresa Farmaki, Astarte Capital Partners

flexible and smarter about ESG. Although you need to find some standard because, as you say, not everyone can be a specialist in everything. Being a Da Vinci today is tough. ESG experts are necessary, but they have to understand investments as well. I think we are getting there. At a recent seminar, about how to invest in ESG going forward, they presented many different angles. It is becoming more interesting and more doable than it was ten years ago, especially with the Paris agreement. The imperatives come down from the state level to the corporate level and get integrated into the accounting. In the future, it will become more commercial to integrate ESG than not."

NOT JUST BLACK OR WHITE

Franzén presents an interesting and complicated question. "You have the food processing industry for example. Food producers, or snacks manufacturers often optimise the amounts of sugar and salt, or other additives to make their product attractive taste-wise. Did you see Jamie Olive's program about sugar? He says that throughout the Iraq war 300 people were amputated due to mines and other war-related injuries. Today, 7,000 people are amputated every year in the UK, due to diabetes type 2, which is correlated with the consumption of sugar. How should we look at companies that are producing food for us?"


Aki Kostiander, United Bankers

ESG is essential for Farmaki and her firm, which is a signatory of the UN Principles for Responsible Investing. She makes an important distinction. "There are two ways investors must behave responsibly: looking at the areas they invest in but also how they invest. The latter has to do with governance and transparency, which is something that people don't discuss that often. This aspect, however, may be easier to tackle, because we have more control over it. As was said, it is difficult to understand all the implications of the sectors or areas that affect each investment, as they are in constant evolution."

THE PRIVATE INVESTOR'S ADV ANTAGE

As manager of an independent family office, Andersson can tailor-make his own approach to ESG integration. "We are fortunate enough to be able to choose how we want to invest. I am a firm believer in sustainable investing and ESG principles, but from a purely capitalistic point of view, because I think that it will be profitable in the long run. Companies that are more efficient, and take care of their employees, will be more profitable in the long run. We are not fundamentalists, however. We can buy a company that is not purely ESG compliant, but we keep sustainability in our mind when we take that decision."

THE INSTITUTIONAL ALLOCATOR'S RESPONSIBILITY

In parallel to the ESG considerations, Andersson is interested in hearing about the feedback asset managers have on institutional investors' internal competence when it comes to real asset investments, especially complex ones. "Do you see many internal restrictions that prohibit pension funds and other institutional investors from investing in real estate and infrastructure, even though they would actually benefit from this type of allocation? Investing in real assets may require special competences for instance in the board, or in the investment committee. If they lack competence, they might shy away from the more complex investments that we have talked about. Does that represent a big hurdle for institutions?"

Holz volunteers to answer Andersson's question. He contrasts the opportunities large institutions can take into considerations, with those of smaller firms. "We see that the bigger pension plans have become flexible. They have built up the internal knowledge and the expertise that allows them to be flexible in the way they invest. This is especially true when it comes to private capital investments, which are typically less controlled and structured. Their investment restrictions often limit smaller pension plans. If, for example, the investment is a foreign shopping centre that costs 250 million, the pension may encounter diversification challenges."

Going back to the responsible investment theme, Holz underlines that private capital investments can pose ethical questions with regards to structuring. Tax havens and offshore structures should also be part of the sustainable investing debate. "In the end, the responsibility lies with the investor, or in this case, the pension plans. They can drive the market."

Interestingly, Holz also observes that the sustainable investing pendulum is swinging back somewhat. "We saw several fund promoters pushing sustainability and ethical investments, with what I thought was quite an interesting approach. But these players may have limited themselves so much in the selection of their investments that they are no longer competitive, and the competition is fierce. As we said, there is so much dry powder in the market, investors have to place money efficiently, they cannot afford to dither for too long, because of their investment strategy. As a result, we see a slight backward movement, away from ethical standards and sustainability. Personally, I very much hope that the tide will turn again sooner rather than later. Again, this is the responsibility of the institutional investors because they can drive the investment strategy, by the way they allocate their money."

LAST WORDS OF WISDOM AND KEY TAKE-AWAYS

Participants are invited to wrap up and share their last thoughts on the asset class.

FROM ALTERNATIVES TO BOND-LIKE INVESTMENTS

Franzén gives a perspective on the evolution of the real asset class's role in portfolio allocation. "When we started investing in real estate ten years ago, people didn't own a lot in real estate. People thought that real estate was an alternative asset. I had a hard time understanding why that was. Real estate in my mind, is probably one of the most basic ways to invest. Then I realised, that sometime, probably in London, some investment bankers decided that real estate should require 95% leverage. Then it became an alternative asset. However, the risk profile of real estate, with only 50% or no leverage at all, looks more like that of a bond. I believe that allocation to real estate will continue to grow in the future because it provides better returns than bonds, and it is quite stable."

REAL ESTATE AND HOME BIAS

At Kåpan, real estate represents a significant part of the portfolio, remarks Falck. "It is our biggest alternative asset class, although while real estate is sometimes perceived as the oldest asset class in the world, it is probably everything but an alternative investment! Our home-market bias is reflected in our relatively large proportion of Swedish real estate investments in our portfolio. Real estate is a very local asset class, and there are clear advantages and broad expertise to be gained by investing where you are located. Overall, our commitment to this asset class is likely to continue, as we search for yields, and partly as we want to stay invested in our home market."

SHUFFLING ASSET ALLOCATION AROUND REAL ASSETS

For Kostiander, asset allocations are starting to move towards a model which includes equities, fixed income, and real assets. Alternatives are then left to include hedge funds, private equity and perhaps commodities, which are real assets, but without yield. "From today's investor perspective, the expansive monetary policies are kind of scary from an inflation point of view. The national debt is piling up because of quantitative easing. Private debt levels are also rising. Put that in the context of the huge Chinese debt burden and US policies, the attitude of the Trump administration's expansive financial policies as well as the ECB's easy stance. At the end of the day, the mountains of debt will have to be handled somehow."

> "...if something goes wrong with that manager, do you have the capacity to retain and recoup the assets you have invested in?"
>
> *Christer Franzén*

PROTECTION AGAINST INFLATION

Kostiander presents four alternatives to tackle the issue of mounting debt levels. "The first one depends on growth. If the GDP grows more than the debt, it may reduce the burden gradually. The second is austerity. The government raises taxes or reduces costs and balances its budget. That is not solution favoured by populist parties. Thirdly, comes the default option. Taking haircuts or not paying the debt, that is not a realistic alternative, in our highly interconnected world. The only likely choice for governments is to inflate the debt away, and that is a solution we have resorted to since Roman times. Property is the oldest investment in the world, and it is an excellent way to avoid capital erosion that comes from inflation. The central banks want inflation, and they would like to keep it moderate, but it is not easy to control the price effect in a market flooded with cash."

"We are facing an exploding mix," warns Kostiander. "Monetary policy is still very expansive while Trump's fiscal policy is kicking in. That is a dangerous cocktail. The real asset

Astarte Capital Partners ERICSSON KÅPAN PENSIONER UB United Bankers RBC Investor & Treasury Services Allianz Global Investors

class is a good place to be in such a situation; equities may be as well. An example is Coca-Cola, with a stock trading at a trailing P/E of 45, while paying out a 3 percent dividend yield. It looks fine on estimated P/E, but still, the prices are very high in general on the stock market. That is where real assets have their place, with inflation-protected cash flows, which can also compensate for the low fixed income part in the allocations today. That includes property, real estate and infrastructure. On the infrastructure side, one must be careful about political risk. These are long-term investments, and governments get elected for limited periods of time. When people change, rules can change affecting infrastructure projects negatively, as it happened e.g. in Norway recently with gas pipeline infra investment projects."

LISTED REAL ASSETS, A KEY PART OF THE REAL ASSET ALLOCATION

Kostiander stresses the advantages of listed real assets again. "You get both growth and active management at a minimal cost. You benefit from economies of scale as well as diversification. You can add a top-down overlay, and there is empirical evidence that these listed real assets return more than private equity or direct investments." Kostiander concludes: "Dedicate a piece of your allocation pie for real assets in your asset allocation but make sure that piece is well diversified. Don't invest everything in your own country, in your own currency, in one style, or in one type of structure, be it co-investments or private equity."

> "I am not a believer in a zero-fee structure, because managers need to be paid. A good manager should make good money."
>
> *Jonas Andersson*

NEW TECHNOLOGIES DISRUPTING REAL ASSET INVESTING

Holz looks towards the future and describes where he believes the disruptions will come from in the real asset space. "If we think about Amazon and about how its business is affecting the retail business. We think about how Uber influences and disrupts transportation. Artificial intelligence, block-chain, and robotics, I believe, will have a huge impact on the real estate and infrastructure industry. These technologies will disrupt how you manage properties and infrastructure projects and how processes will be automated. They may completely and dramatically change how we invest and how we manage assets. We are entering interesting times."

MANAGEMENT FEES: THERE IS NO FREE LUNCH

Deblanc addresses the topic of management fees. For him, there is no free lunch. "I just don't buy into the idea that you can hire a good team and retain that team and have it there for the duration of the investment without actually compensating them fairly compared to the market, for the value they add. If they are unhappy, maybe they are not going to provide the greatest service to their clients. There is no free lunch. Some people may perform relatively well, but on average, you need to compensate people fairly. I believe the Nordic culture is actually very aligned with those thoughts, perhaps more so than other cultures."

"Another real issue is the fairness of the compensation for the added value. In fact, people are willing to pay for what you bring. The honest question that we should address is how much of the alpha, or value-added, is chargeable to the investor. If managers can't deliver returns that are in line with the asset class or if they take too much risk to justify that spread, the game will end badly."

MANAGER SELECTION, KEY IN PRIVATE EQUITY INVESTMENTS

Franzén stresses the importance of selecting the right manager and cautions against dwindling teams. "There is a risk all investors face when dealing with illiquid assets. With UCITS funds, the performance does not diverge much from the index. A good manager can add one or two percent to the index's return. If a lousy manager shows minus five in relative terms, you can sell the fund and find someone else. But when you invest in a private equity structure, it is essential to know who you pick. There are examples where a smaller first-time fund performed well. This attracts investments into the second fund, which does not perform as well, and the manager cannot raise a third fund. Most of the talented people leave, and investors are left without the competence to manage their assets. If you already are a local real estate investor, you may know people who can help you, and you will do well. If not, it will be trickier. If you are dealing with smaller mid-cap private equity investments, it could be a nightmare. To stress the critical point to consider: if something goes wrong with that manager, do you have the capacity to retain and recoup the assets you have invested in?"

INFRASTRUCTURE IN PARTICULAR NEED FOR EXTERNAL MANAGEMENT

Like Franzén and Falck, Andersson finds that real estate will continue to be a relevant asset class. For his family office, it will likely continue to be a combination of private equity, co-investments and direct investments. Where external managers add value, in particular, is in infrastructure, and especially in direct lending, as described by Deblanc. "Those are two are areas in particular where you need deal flow. You need an external manager because you can't invest by yourself very often, especially given that infrastructure projects are usually very large. Even a few investors co-investing together can't buy a highway on their own, for instance. Funds play an important role in that part of the asset class."



On the subject of fees, Andersson adds: "I am not a believer in a zero-fee structure, because managers need to be paid. A good manager should make good money. Pressure may persist in the management of plain-vanilla product. But I have no problem paying up for a good manager."

A SUSTAINABLE FEE MODEL

Farmaki has strong opinions about fees and presents the way her firm, Astarte, has decided to charge investors in a way they believe rewards performance best. "Realistically everybody understands that there are costs associated with running a portfolio of investments properly. Nobody has a problem paying for those costs. The issue starts when fees go beyond that. How much is it reasonable to pay someone on an ongoing basis? Because it is a close-ended structure, investors cannot just leave if they are unhappy. The real issue comes when managers are investing other people's money, usually with very low alignment. Success-linked compensation is key. The current model of two and twenty, or one and a half and twenty, or even one and a half and fifteen, works well for certain sizes. Sometimes it can generate the wrong incentives."

Farmaki illustrates her point, by describing two situations that have earned this standard fee model a bad reputation. "One version is the one where very large managers of multiple, multi-billion-dollar funds keep charging one and a half or two percent management fees. Is that reasonable? They need some link to or impact on success. The other version is the one where managers take advantage of the closed-ended structure of their product. They go through the investment period, they deploy the capital and then realise that they have actually not been that successful. They no longer expect any carry or returns, so they just sit on the investments to get the management fees."

To remedy these issues, Farmaki proposes the model her firm has adopted. "We have a transparent fixed budget, and we tell our investors how much the running of Astarte Capital Partners costs. We then show how we spread those costs proportionally over the investment period so that we are comfortable that we can run our operations until we can reasonably expect to generate returns. From there, our fees are success-based only. That is the model we found that best aligns our incentive with that of our investors."

Astarte Capital Partners · Ericsson · KÅPAN Pensioner · UB United Bankers · RBC Investor & Treasury Services · Allianz Global Investors

NordicInsights

HEDGENORDIC ROUND TABLE DISCUSSIONS

The HedgeNordic series of round table discussions titled “Nordic Insights” aim to bring together industry professionals and experts in their field in a vivid discussion. The setup allows to look at and discuss a specific topic within the financial industry from various different angles, and hear of different opinions and approaches. The group would typically consist of a colourful mix of representatives from the financial industry. The combination of having a relatively small, intimate group of individuals for the discussion behind closed doors in combination with a wide circulation to a relevant audience in the Nordic region through a summary of the discussion in a convenient read-up paper combines the best of the two worlds of professional and personal relationship building and broad communication and branding.

The size of the group and format chosen, combining a casual lunch followed by the actual work session and discussion give an excellent opportunity to network and get to know the participants and organisations behind them in both a more personal and professional manner.

The Round Table Discussion is hosted without audience, behind closed doors. The moderated discussion will evolve around topics pre-defined in collaboration with the participants prior to the event. To insure a dynamic and lively discussion the specific questions that will be discussed are not disclosed prior to the get together.












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HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals and those who take an interest in the region.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

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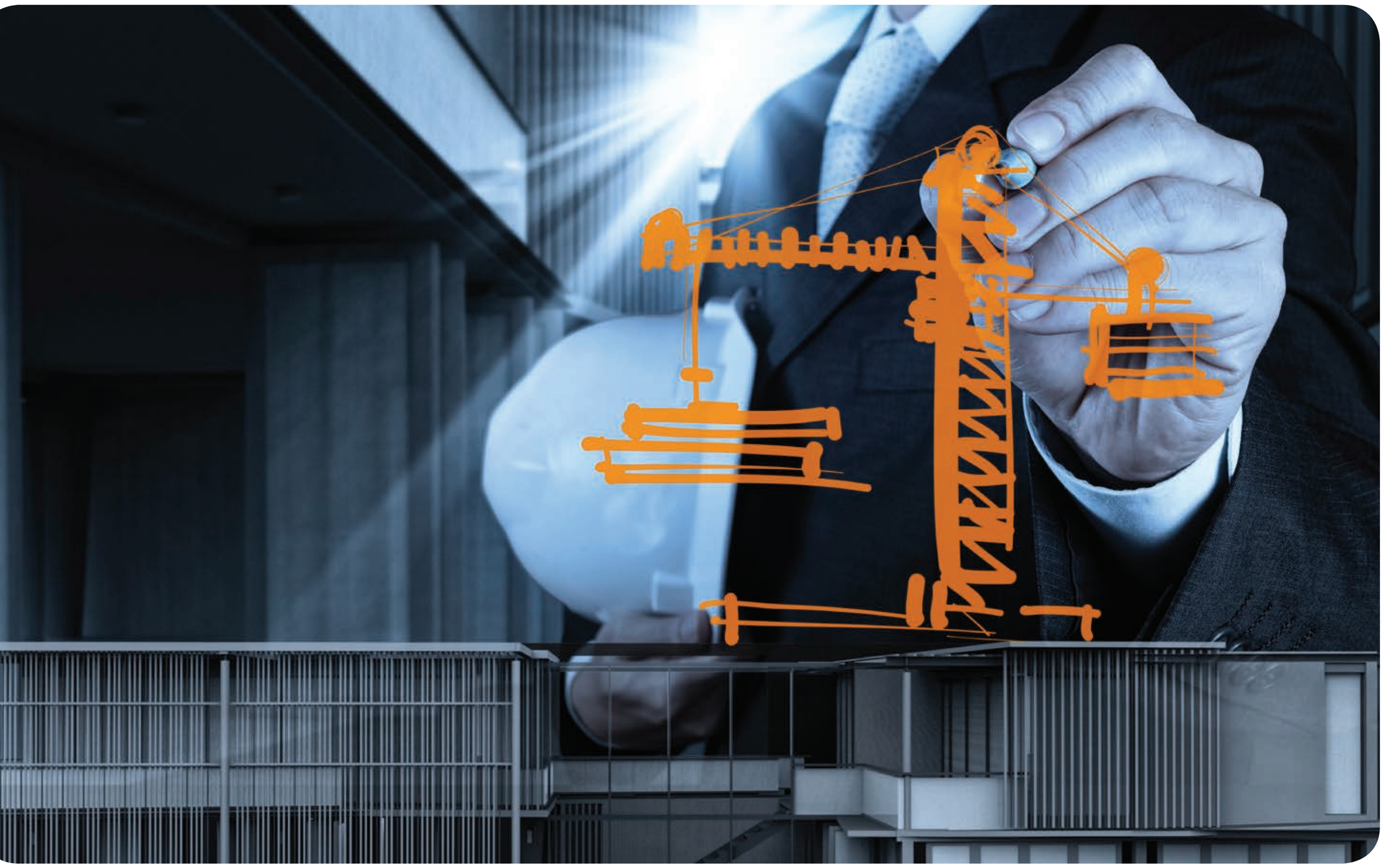

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