

Yield-Starved Institutional Investors Look to Private Markets

Stockholm (HedgeNordic) – Identifying attractive sources of returns is part of the daily business for investors. In today's environment, with market returns on stocks and bonds over the next decade expected to fall short of historical averages, that search has become even harder. Institutional investors, such as insurance companies, pension funds and other institutional investors are ever more turning to alternative investments – private equity, real estate or hedge funds – to bullseye their return targets.

Traditional public fixed-income investments are a mainstay of most institutional portfolios. The portfolio guidelines imposed at Swedish insurance company PRI Pensionsgaranti, for instance, require exposure to fixed-income investments between 40 and 65 percent. "PRI Pensionsgaranti has always had a large presence in liquid fixed-income markets, due to our somewhat uncertain liability side," explains Peter Ragnarsson, Head of Alternative Investments at PRI (*pictured left*). PRI Pensionsgaranti provides credit insurance for the pension commitments of policyholding companies. Since PRI's insurance risk is tied to the insolvency of policyholding companies, the insurer's credit losses largely depend on the business climate.

With interest rates at historic lows and the prospect of rising rates, institutional investors are trying to reposition their portfolios for a possible rising rate cycle. "A large challenge today is how to think about portfolio allocation as we are getting closer to the end of the cycle," points out Ragnarsson. "Equity valuations are stretched, we have low interest rates and can't rely on diversification from the fixed-income portfolio in the next downturn."

AFA Insurance provides insurance coverage to 4.7 million Swedish employees and faces a similar challenge but at a much larger scale. AFA maintains an investment portfolio worth SEK 195 billion, of which 41 percent constitute fixed-income investments and 31 percent stocks. According to Mikael Hultdt, Head of Alternative Investments at AFA Insurance (*pictured right*), the biggest challenge in today's low-return environment is "finding relevant investment opportunities that have attractive risk-return characteristics and that are not too short-term in nature."

Institutional investors are increasingly turning to alternative assets to better navigate an environment characterized by low expected returns from bonds and stocks, geopolitical concerns and a growing set of risks such as, most recently, the coronavirus. PRI Pensionsgaranti and AFA Insurance are no exception. Permitted to maintain an allocation of between 10 and 30 percent to alternative investments, PRI increased its allocation to alternatives from eight percent at the end of 2013 to 24 percent at the end of 2019, close to the upper end of the range. AFA Insurance's exposure to alternative investments, excluding real estate, doubled from six percent at the end of 2013 to about 12 percent at the end of 2019.

The Benefits of Alternatives

PRI Pensionsgaranti's increasing allocation to alternatives has two primary purposes in the current environment. "First, we see our portfolio of alternative investments as a return enhancer in today's low interest rate environment," explains Ragnarsson. "By going for illiquid investments, we should be able to create higher returns than from public markets. Although with a different risk profile." Second, Ragnarsson views alternative investments as "a risk mitigation tool, both in terms of diversification created by our hedge funds and volatility dampening stemming from our private

market investments.”

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“Alternatives have grown in importance for most asset allocators,” emphasizes Huldt. This development is attributable to “a combination of attractive historical returns and fundamental shifts in market dynamics supporting the promise of strong future performance.” On the equity side, “more companies choosing to stay private combined with fewer IPOs and public companies” represents one such fundamental shift that leads to the expansion of private equity as an asset class. On the credit side, “regulations have forced banks to reduce activities in some market segments, opening up for others including institutional investors,” argues Huldt. This development, in turn, is fuelling the growth of private credit.

Opportunities in Alternatives

Huldt reckons that “there are many attractive opportunities in the alternative credit space.” He points out that “the supply and demand dynamics are still quite favourable and the markets, especially in Europe, are quite nascent.” Ragnarsson corroborates Huldt’s observation, accentuating that “we still think we can find attractive investments in the credit space compared to our liquid portfolios, both in direct lending and structured credit.” Ragnarsson stresses that “manager selection becomes even more important when we are late in the cycle.”

Aside from opportunities in the credit space, Huldt also sees “attractive opportunities in other areas such as private equity, real estate, infrastructure and so on.” However, he emphasizes that “some of these markets tend to be more competitive and are, in many cases, suffering from a large inflow of institutional capital in recent years.” Ragnarsson, meanwhile, adds that “the hedge fund space is starting to look interesting again.”

With currently around 24 percent exposure to alternative investments, PRI Pensionsgaranti plans to increase the allocation to alternatives to 30 percent, “mainly by increasing our presence in private markets.” At the end of last year, about one-third of the insurer’s allocation to alternatives comprised hedge funds, with the remaining two thirds equally divided between real estate and private credit. In the past two years, PRI “also added private equity and infrastructure to the portfolio, with the aim to grow meaningful allocations over the next few years,” states Ragnarsson. However, “the commitments made are still very early in the investment periods and so far, have not had a major effect on the portfolio allocation.”

AFA Insurance, meanwhile, maintains a current allocation to private equity between eight and nine percent, and three percent to private credit. The Stockholm-based insurer has also boosted its portfolio of alternatives by adding infrastructure. “We recently started to build an exposure to infrastructure, which initially is also targeted to be around three percent,” says Huldt. The underlying rationale behind the increasing exposure to infrastructure is “the ability to diversify the portfolio and leverage off our ability to take on illiquidity.”

Biggest Challenges

While alternative investments are becoming increasingly popular among institutional investors, there are certain challenges and limitations associated with investing in alternative asset classes. “With the increased focus on alternative and illiquid investments, it is important not to get too

carried away. There are several risks that need to be remembered,” warns Huldt. Whereas many investors focus on the relative attractiveness of alternative investments compared to more liquid and traditional asset classes, “one cannot lose sight of risk and returns on an absolute basis.”

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The expected future returns for some strategies and asset classes “may be meaningfully lower than historical,” points out Huldt. He recommends investors to ask themselves “whether the strategy at hand is still sufficiently attractive to compensate for the inherent risks.” In addition, “operational risks tied to alternatives are easy to underestimate, especially for new entrants,” Huldt believes, as well as “new issues such as fraud and ESG risks coming up as the alternative asset classes grow.”

Ragnarsson and his team at PRI are confronting several challenges in their pursuit of increasing the allocation to alternative investments. “When building up a new portfolio within private markets, it is always a challenge to be selective and have patience,” points out Ragnarsson. Another hurdle involves the “need to model future cash flows and understand the amounts you have to commit to being able to reach your target allocation over a five-year horizon, for instance.” Due to the nature of many strategies in the alternatives space, investors “often have to “overcommit” to be able to reach the exposure they want in the portfolio.” Another challenge for PRI revolves around liquidity or the lack thereof. “A challenge for us is also to give up liquidity and understand how that potentially is effecting our liability side,” concludes Ragnarsson.

Conclusion

In an environment of low interest rates, weak growth and low expected returns from traditional asset classes, institutional investors are finding it increasingly challenging to earn reasonable rates of return without an unacceptable increase in risk. As a result, institutional investor appetite for alternative asset classes has been on the rise, as more investors are turning to alternative investments such as private credit, private equity and infrastructure in search of returns. Yet, money managers with extensive experience in the space are warning against the unreasonable extrapolation of historical returns into the future and the underestimation of operating and liquidity risks inherent in alternative investments.

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