NORTHERN TRUST

ASSET OWNERS CREATE A MORE POWERFUL VOICE

- Asset owners are becoming more powerful. They are coming together in ways that were not possible before and focusing on the issues that matter to them.
- Some of the ways that asset owners are coming together is through consolidation and collaboration.
- ESG has become a vital issue, and asset owners are affecting change and helping build standardisation in ESG measurement.
- They are shifting into new and more esoteric asset classes, and redefining asset allocation.
- Asset owners are leveraging data and technology to build insights and level the playing field, engaging with investment managers on their performance.

Around the world, asset owners are facing new and developing challenges.

Around the world, asset owners are facing new and developing challenges. Whether it is growing inflationary pressures, political volatility, climate change, demographic and retirement shifts, or changing operational or business models, asset owners are facing a myriad of pressures, many of which didn't exist a decade ago. The good news is that they are increasingly coming together and driving the agenda across a range of issues that matter to them.

Northern Trust's Mark Austin, Head of Asset Owners, UK and Pensions and Insurance Executive, Europe, Melanie Pickett, Head of Asset Owners, Americas, and Leon Stavrou, Head of Australia and New Zealand, believe that asset owners are taking a more active role in driving positive outcomes for their constituents and at the same time, creating a more powerful voice in the institutional investing industry.

How are they doing this? They are building economies of scale through consolidation, spearheading new asset allocation models and approaches, moving into alternative and esoteric assets, pursuing active ownership and stewardship, building momentum around sustainability and ESG, and embracing new digital and data insights to enhance performance and create holistic portfolios.

"Asset owners have reached an inflection point. They are aware that they are facing increasing complexities, but they are also aware that, more than any other time in history, they are able to affect change. They have gone from being price takers to price makers, and they are doing that by working together, by embracing new technologies, and by leading the way on ESG," says Pickett.

THE POWER OF CONSOLIDATION AND COLLABORATION

One of the ways in which asset owners are changing the landscape is through consolidation. Though consolidation trends and themes vary in different parts of the world, the direction of travel is clear. Many asset owners can no longer afford to go it alone. There is strength in numbers.

"Complex portfolios equal complex data which results in a complex operating environment for asset owners, as the pressures increase on investment teams and institutions. Consolidation makes more and more sense in respect to getting scale. Getting access to the right managers is also a factor. Consolidation leads to new investment opportunities. The big players in the private investment space, for example, are people who are able to command entire funds or entire deals," says Pickett.

Consolidation is also allowing asset owners to develop more analysis and insight into the performance of their managers, according to Austin. "As asset owners come together and become bigger, they can afford to use tools like data science which allow them to look more closely at what managers are doing, how they are doing it, and what the end result is. The focus is on greater attribution and how managers are converting ideas into performance," he explains.

Consolidation can also help asset owners ensure that their broader asset allocation strategies will not impact the overall pension plan, particularly in the case of illiquid assets, he suggests.

"If you want to allocate to an alternatives mandate, you don't want to have to sell the illiquid assets ahead of the point at which they would mature. You want to be sure that the illiquidity is a small part of the plan and will not be challenged. If you are in a much bigger plan, because you have more harmonised flows in and out, you can afford to put illiquid assets in place because you have greater access to other liquid assets."

Asset owners can also use their size to flex their muscles when it comes to issues like engagement, and to grapple with the costs and complexities of regulation, he says. "The bottom line is that asset owners have realised that if they consolidate and come together, they can dictate their own future, and I think that's only right."

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> *Complex portfolios equal complex data which results in a complex operating environment for asset owners, as the pressures increase on investment teams and institutions.*
>
> **MELANIE PICKETT**
> Practice Executive,
> Head of Front Office Solutions

WHAT CONSOLIDATION LOOKS LIKE GLOBALLY

Asset owners are coming together in different ways in different parts of the world.

AUSTRALIA

In Australia, consolidation has been driven by regulators. The Australian Prudential Regulation Authority[i] (APRA) has put pressure on the $2.5 trillion superannuation sector to merge. There were a record 15 mergers in the year to October 2021, with a number of 'super funds' building considerable power. As the fifth largest market by funds under management, Australia's superannuation funds are responsible for building sustainable retirement outcomes for more than 16 million people.[ii]

Research from JP Morgan reveals that half of surveyed industry executives believe the number of mergers will grow even more over the next few years. Almost one-quarter believe there will be fewer than 50 funds by 2025, which would mean two-thirds of today's funds will no longer exist. If the number of funds declines to fewer than 75 over the next four years (by 2025), this could consistently result in 20 mergers or more a year.[iii]

APRA is also heavily involved in pushing through further consolidation. "The primary driver for consolidation has been regulatory pressure. APRA has really set the agenda around the number of funds and investment options that are in the market, too many from its perspective," says Stavrou.

Australia's 'mega funds' will change the investment industry landscape beyond their local market. Already, players are looking to beef up or build operations in London and New York.[iv]

"If you look at the investments of the mega funds and how they are deploying their large assets, one aspect is the volume of inflows. These types of funds could have a billion dollars of inflows a month to deal with. They have got to invest across their asset classes every month, so finding new avenues to deploy that money means they need to start thinking globally in terms of their operations. What we are seeing is that these funds are starting to open up offices in London or New York so they can run global operations, and be close to where the deals are, particularly with private assets or infrastructure," says Stavrou.

UNITED KINGDOM

In the UK, significant consolidation took place in the defined benefit (DB) sector in 2018, when local government pension funds pooled their assets.[v][vi] Over 80 local authority pension funds within the UK Local Government Pension Scheme (LGPS) in England and Wales, which now have combined assets under management of more than £276 billion,[vii] created eight separate pools. [viii]

There are other avenues of consolidation as well. The Pension Protection Fund takes over defined benefit (DB) pension assets when an employer becomes insolvent. It currently manages £38 billion for 288,000 members.[ix] In March, the fund saw its investments in forestry assets grow by 20% over the year to hit £1 billion.[x]

Additionally, the UK is poised to accelerate DB superfund growth of its own. In November 2021, TPR approved Clara-Pensions, the first DB super fund to meet 'tough new standards' of governance and administration.[xi] Based on interest already shown, Clara-Pensions plans to take on as much as £5 billion in pension liabilities over the next five years, as pension plans look at options to de-risk. [xii]

While Clara-Pensions is using a 'bridge to buyout' model, other models are also being proposed, including an 'ongoing' model suggested by The Pension SuperFund, which would pay pension benefits on an ongoing basis, rather than completing a buyout. [xiii]

On the defined contribution (DC) side, the occupational defined contribution (DC) pension market has consolidated by nearly 40% in a decade, according to The Pensions Regulator (TPR). [xiv] The number of pension plans with 12 or more members has declined by 63% since 2012. Master trusts are the beneficiaries of that consolidation, increasing assets by almost 50% to £78.8 billion over the course of 2021, according to TPR's 2022 DC Trust Report. [xv]

EUROPE

For continental Europe, consolidation has been a key trend for some decades for the retirement industry. In November 2020, 32% of European pension plans were planning to fully consolidate with another pension plan over the following 12 to 24 months, according to research from Cerulli Associates. [xvi]

In the Swiss market, 304 occupational pension funds ceased to exist between 2014 and 2018, while over the two decades to 2018, [xvii] the number of pension plans in the Netherlands decreased by 75%. [xviii] The Dutch market, with fewer than 200 pension plans, is also expected to consolidate further. [xix] A similar story is being played out in Sweden, where regulation and a reduction of the number of funds in the Swedish Premium Pension System (PPM), means the industry could be facing further consolidation,[xx] while in Germany, energy giant E.ON has decided to set up its own fund to consolidate the group's occupational pensions.[xxi]

THE MIDDLE EAST

In the Middle East sovereign wealth space, merger announcements include Oman Investment Fund (OIF) and State General Reserve Fund (SGRF), coming together to create a fund with expected assets of approximately $18 billion,[xxii xxiii] Abu Dhabi Investment Council (ADIC) becoming part of the Mubadala group with a combined portfolio worth over $200 billion,[xxiv] and Saudi Arabia's merger of two of its pension and insurance funds to create a new entity with over $250 billion in assets under management.[xxv]

NORTH AMERICA

The trend is also driving change in North America. Consolidation of pension plans in Canada is not a new phenomenon. This is especially true amongst public pension funds where they have realized the investment and operational efficiencies they can gain by appointing a pension manager to manage their collective assets. Recently, for example, the Alberta Teachers' Retirement Fund, The Workers' Compensation Board and the Alberta Health Services transitioned the investment management of their assets to the Alberta Investment Management Corporation (AIMCO). The funds noted that this move will help them increase scale and reduce redundancies.[xxvi] More importantly, it allows them to gain access to certain investments which they otherwise would not be able to access. And in the US, the state of Illinois enacted the Pension Consolidation Act in 2020, designed to consolidate police and fire pension plans to increase investment returns and decrease fees.[xxvii]

Consolidation is a mixed bag in the US however. As Willis Towers Watson has pointed out, many DB plans remain open in the country, and typically have a much lower value of benefit provision (and subsequent cost to the sponsoring company), than a UK DB plan would have.[xxviii] That, combined with the fact that US employees typically have a 401k (DC) plan, means that the system is looking more sustainable.

"There is a difference between how different institutional investor groups are consolidating in the US. In the healthcare sector, for example, it is largely an M&A story. As healthcare costs rise, there is pressure on margins, and healthcare providers are consolidating and buying doctors' offices to increase scale. Other asset owners are not in the same position," says Pickett.

ASIA EX AUSTRALIA

Many asset owners in Asia are also bucking the consolidating trend, largely because of the way they are configured. In general, a significant percentage of asset owners, whether they are sovereign wealth funds (SWFs) or pension plans, are government backed and run. While Asian asset owners are facing many of the same challenges as other asset owners globally, they are addressing those challenges by outsourcing investment decision-making to external managers rather than retaining the function in-house.

Asset owners are also coming together in other ways, by forming consortiums to drive changes around key issues, particularly sustainability. One example is the UN-convened Net Zero Asset Owner Alliance, an international group of institutional investors with $10.4 trillion in assets under management, committed to align portfolios with the 1.5C scenario of the Paris Agreement, for example.[xxix] The group recently published a paper, encouraging investors to engage more with business sectors and public policy makers, rather than solely excluding certain investments from their portfolios, in order to affect change.[xxx]

Another way they are coming together is by collaborating with each other and with their investment management partners, for example on the reporting of ESG. In 2021, the first ever limited partner (LP) and general partner (GP) partnership to standardise ESG reporting was launched,[xxxi] when CalPERS and global investment firm Carlyle led a group of GPs and LPs representing more than $4 trillion in assets under management, to affect change. The group's objective is to 'streamline the private equity industry's historically fragmented approach to collecting and reporting ESG data in order to create a critical mass of material, performance-based, comparable ESG data from portfolio companies', it says.[xxxii]

Asset owners are also collaborating to gain access to less liquid assets. The Pensions Infrastructure Platform (PiP) was set up by UK pension plans to align interests and gain exposure to core infrastructure, for example.[xxxiii]

Over the last decade, ESG has become a vital issue for asset owners.

DRIVING THE AGENDA ON ESG

Over the last decade, ESG has become a vital issue for asset owners. 22% of institutional investors surveyed by Investment Association (IA) last year said that they integrate ESG into 75% or more of their portfolios, and this is set to grow over the next two years.[xxxiv] Other reports put this figure higher. According to research from FTSE Russell, sustainability has become standard, with 84% of asset owners globally either implementing or evaluating sustainability in their portfolios.[xxxv]

The IA survey reveals that brand and reputation has overtaken returns as the main ESG driver, while alignment to net zero commitments acted as an accelerator. For its part, the FTSE Russell survey suggests that risk management considerations have driven sustainable investment, with climate and carbon the leading priorities for 67% of respondents.[xxxvi]

Elsewhere, research by the World Economic Forum has shown that almost one third of asset owners surveyed are considering allocations to sustainable agriculture, such as AgTech venture capital and land conservation. One third is assessing private market allocations to women and minority-owned organisations and managed funds, and more than one fourth to microfinance.[xxxvii] Additionally, one fourth are considering allocations to green bonds and blue bonds, such as ocean conservation and sustainable fisheries.[xxxiii]

Pension plans globally have also increased their focus on impact investing, (impact assets grew to $715 billion in 2020, an increase of over $200 billion on the prior year, according to the Global Impact Investing Network).[xxxix]

In November 2020, several major Canadian asset owners made a high-profile stand for ESG standardization to be passed into federal law. The CEOs of Canada's eight leading pension plan managers (also popularly referred to as the Maple 8), with combined assets of approximately C$1.6 trillion, signed a statement emphasizing the importance of a more complete and consistent disclosure on ESG practices from investors and corporations. Each of these entities typically competes with each other on various deals, but in this case joined forces with a goal to bring real change in how the country takes ESG into account.[xl]

Today, it is no longer possible to pay lip service to ESG considerations, or to 'greenwash' products and not expect those products to be scrutinised. Asset owners are expecting their investment managers to hold themselves to a similar standard as they are holding themselves, not only with regards to climate change and the 'E', but also on the 'S' and 'G' of ESG.

"Asset owners are influencing their investment managers by formalising the ESG requirements of investment management agreements, or even asking or requiring that their managers being signatories to the UN's Principles for Responsible Investment. It's a way to hold investment managers to account, and to assess how they have actually performed," says Stavrou.

Last year, the Ford Foundation announced that it was ending further investment into fossil fuels and seeking out climate-friendly investments.[xli] It has said it is also holding its investment managers to account on Diversity and Inclusion, highlighting that in the US, women and people of colour only manage 1% of the $71 trillion marketplace. [xlii] As a result, Ford Foundation has taken the deliberate step to promote investment with diverse fund managers, 'to reduce social injustice and build a stronger, more inclusive economy'. In a similar move, Yale's chief investment officer David Swensen announced last year that the investment managers who manage the university's endowment needed to take Diversity and Inclusion seriously, with the fund stepping in to monitor their progress. [xliv]

"For many institutions, diversity is top of mind, as is governance on their own managers," says Pickett.

Today, it is no longer possible to pay lip service to ESG considerations, or to greenwash' products and not expect those products to be scrutinised.

Asset allocators have also banded together on the issue, notably with the creation of the Institutional Allocators for Diversity, Equity & Inclusion (IADEI) group, a consortium of asset owners, primarily endowments and foundations with over $2 trillion in assets, who are focused on driving more diversity, equity, and inclusion not only within institutional investment teams and portfolios, but also across the investment industry, including directing capital towards diverse fund managers.[xlv] The broader focus on ESG is not without its challenges, however. "For the industry, the homogeneity of ESG data remains a challenge. At the moment, you can get ESG data from one provider and it will tell you one thing, whereas the next pension plan might get ESG data from another provider, and it will tell them something different. There's no commonality in it," comments Austin.

It is no surprise then, that rating agencies have come under fire.[xlvi] In a world where companies have varying business practices, operate in different geographies and industries and outsource different parts of their value chain, the challenges are profound. International standards and metrics are in development to address some of these issues, with regulators also driving change.

There are definitely still challenges with the integration of ESG factors. There are actually over two hundred reporting and disclosure measures and frameworks around the world. You can imagine what that could lead to in terms of selective reporting and inconsistent disclosures that are not comparable.

LEON STAVROU
Practice Executive,
Head of Australia and New Zealand

KEY DEVELOPING STANDARDS AND METRICS FOR ESG

International Sustainability Standards Board (ISSB): new accounting standards to help guide companies on what sustainability disclosures should be made to investors to supplement financial statements.[xlvii]

World Economic Forum Stakeholder Capitalism Metrics: designed to improve consistency and comparability of information reported by companies, increase corporate ESG reporting.[xlviii]

EU Green Taxonomy: the EU taxonomy is a classification system, establishing a list of environmentally sustainable economic activities.[xlix]

EU Corporate Sustainability Reporting Directive (CSRD): EU regulation which requires certain size of companies to disclose information on the way they operate and manage social and environmental challenges.[l]

Sustainable Finance Disclosure Regulation (SFDR): investment managers will have to disclose ESG risks in their portfolios. Information will have to be disclosed on website as well as fund documentation.[li]

The Task Force on Climate-Related Financial Disclosures (TCFD): created by the Financial Stability Board (FSB) to develop consistent climate-related financial risk disclosures for use by companies, banks and investors in providing information to stakeholders. [lii]

SHIFTING ASSET ALLOCATIONS

Even as they focus on ESG factors, asset owners are well aware that finding consistent performance remains a challenge. For many, the answer has been to move up the traditional risk curve by accessing alternative and esoteric asset classes. Alternative asset investment managers, who are currently holding more than $13 trillion in AUM, are expected to hold $23.21 trillion by the end of 2026, according to data from Preqin.[liii]

The asset allocation by global institutional investors to real estate, private equity, and infrastructure in the 20-year period moved from about 7% to above 26%, according to the Thinking Ahead Institute Global Pension Assets Study 2021.[liv] Within the alternatives sphere, it is private assets that are seeing the most significant growth, expected to have hit $8 trillion at the end of last year,[lv] with investors looking at everything from private equity to private debt, real estate and infrastructure, and from ESG-aligned investments to sustainability-focused and impact investments. Preqin figures suggest that private equity and venture capital AUM will hit an excess of $11 trillion by 2026, accounting for almost half (49%) of alternative assets.[lvi]

High profile asset owners raising their alternative asset market share include CalPERS, which announced that it would be increasing its private equity portfolio from 8% to 13% of total assets, (roughly $25 billion), [lvii] and the $75 billion Los Angeles County Employees Retirement Association, which raised its private equity target from 10% to 17% of its portfolio.[lviii] Even US corporate DC plans are seeing constraints on allocations change. In 2020, the Department of Labor said that designated alternatives with private equity components could be part of a prudent mix of investment options under 401K and other ERISA-covered individual account plans.[lix]

Investors are also looking at digital assets as a broader opportunity set. Seven in ten institutional investors expect to buy or invest in digital assets in the future, and more than 90% of those interested in digital assets expect to have an allocation in their institution's or client's portfolio within the next five years, according to Fidelity Digital Assets 2021 Institutional Investor Digital Assets Study.[lx] The growth of digital assets – which include cryptocurrencies, stablecoins, central bank digital currencies (CBDCs) and digital tokens – has also been supported by the growth of digital infrastructure, for example by new initiatives from central securities depositories (CSDs). Digital assets are also supporting the growth and development of private assets, as digitisation can enable a greater degree of transparency and efficiency, both of which have been seen as challenges to investing in alternatives.

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The shift towards digital and private assets and alternatives comes as asset owners are changing their broader asset allocation approaches, suggests Pickett. "Everything in the investment world is becoming hybrid. There is no more public or private, the conversation has moved beyond that to risk factors. The world is becoming hybrid, with public managers holding private assets. That puts the burden on organisations to have a holistic view of their portfolio," she says.

Asset owners have recognised that traditional asset allocation approaches are no longer fit for purpose in an increasingly interconnected world, she suggests.

"The whole style of asset allocation is changing. The traditional strategic asset allocation buckets of fixed income and equity are no longer meaningful. For example, a fixed income manager may have commodities exposure," she says.

Large asset owners are increasingly acting like investment managers, through their direct investments, through the increased outsourcing of trading and other front office functions, and through their purchasing power.

THE RISE OF DATA

It is not just investment approaches that are becoming more hybrid. Large asset owners are increasingly acting like investment managers, through their direct investments, through the increased outsourcing of trading and other front office functions, and through their purchasing power. Drawing key insights from data has become a critical function of that hybrid transition, not only in order to build robust operational frameworks, but also for better integration of ESG factors and esoteric assets. 18% of respondents to MSCI's global institutional investor survey 2021[lxi] felt that the lack of data was the biggest barrier to ESG integration, for example.

"Investors have always had to deal with a mountain of unstructured data that lives in deal documents, news sources, portfolio commentary from managers, and all the different communications our clients receive. Many of our clients are receiving tens of thousands of communications from their managers a year. The challenge isn't 'did you curate and synthesise it', the challenge becomes, 'did you read it all?' It's unstructured, disparate, and manual," says Pickett.

She highlights the fact that large asset owners are diversified across every instrument, macro factor, geography, and segment. "They are having to process the same data as a global multi-strategy hedge fund but operating on shoe-string compared to an investment manager. If you think about the fact that asset owners are responsible for tracking every micro and macro geographical segment, the amount of research that they are doing is really impressive. What they need to spend their time on is taking synthesised data and using it to make portfolio decisions, not going through thirty thousand documents," she says.

Asset owners have recognised that qualitative data management is not scalable, and that automation is critical. "If you think about the volume of data that's being generated and consumed, it's impossible to analyse that without significant levels of automation. Being able to categorise and process and build models off the back of that automation is really important. But you also need the people to define those parameters and make those decisions. You need to understand what the data you are looking at actually is," says Stavrou.

While data challenges do vary globally and are dependent on the needs of the asset owner, some key challenges are around developing consistent, transparent and mature data for ESG measurement market to market, developing independent, timely, and reliable valuations, particularly for private assets, generating behavioural analytics, and building transparency into processes.

One solution asset owners are turning to is data warehousing.

Data warehouse solutions can be fully outsourced data management functions. They can include the people, governance, and operational aspects of data management, including enrichment and translation. Asset owners need quality, reliable golden sources of data, and warehouses allow for that data to be distributed or integrated into other systems and tools that asset owners may want to adopt.

Other solutions will help asset owners draw insights into their investment managers and assess different aspects of their performance. Last year, Northern Trust entered into an agreement with Two Sigma to provide quantitative analytics to clients, for example.[lxii] Venn is a cloud-based investment analytics platform created by Two Sigma, which provides enhanced portfolio insights and analytics, allowing both investment managers and asset owners to better understand investment risks and opportunities, delivered through cloud-based software.

"The silver lining is that technology is keeping pace with the rise of data. Machine learning is helping harness unstructured content. Technology is changing the landscape, while data science is really helping asset owners understand the skill and the persistence of returns of their asset managers. Was it persistence, luck, alpha, or beta? Passive funds and private funds are the future, and if you are just getting market beta and paying alpha fees, that is something that our clients need to figure out. That can be a big drag on the portfolio," says Pickett.

Asset owners need quality, reliable golden sources of data, and warehouses allow for that data to be distributed or integrated into other systems and tools that asset owners may want to adopt.

ASSET OWNERS GET MORE POWERFUL

Asset owners are facing more challenges than ever before, and those challenges include navigating a low growth, low rate and high debt environment, even as inflationary pressure, political volatility, and climate concerns all add their own complexities. The good news is that asset owners are getting more powerful.

By coming together, either through consolidation or through industry engagement, by adopting new asset classes and new technologies, by engaging with investment managers and embracing new asset allocation strategies, asset owners are able to flex their muscles in ways they had not been able to before.

The next decade will see even more change as asset owners consolidate further, as they increasingly leverage technology and data management tools to generate insights and create standardisation, as they stand at the vanguard of environmental and social change, and as they build stronger, more transparent, and better governed models.

As we enter the future, many things will change, but some things will remain the same. Whatever the complexities and opportunities, asset owners will continue to focus on the needs and wellbeing of their underlying stakeholders and constituents and put those stakeholders and constituents first.

LEARN MORE

To learn more please contact your Northern Trust representative or visit NorthernTrust.com.

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