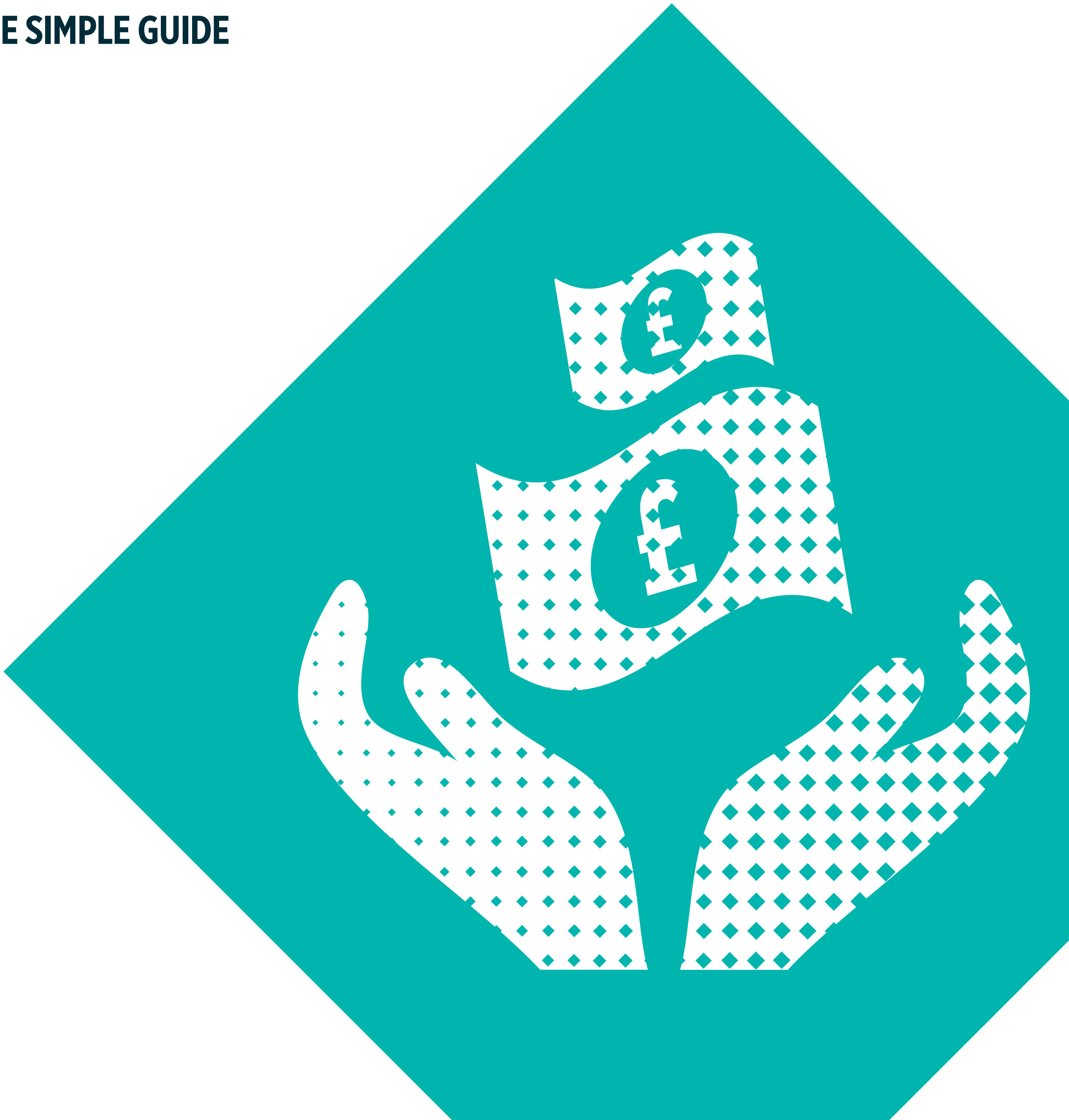
PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

October 2016

GENERATING INCOME FROM PRIVATE MARKETS

MADE SIMPLE GUIDE



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FOREWORD

IN TODAY'S COMPRESSED RETURN ENVIRONMENT, A GROWING NUMBER OF PENSION SCHEMES ARE LOOKING TO GENERATE ADDITIONAL INCOME BY INVESTING IN PRIVATE MARKET ASSETS.

We believe this is the right response, but as a first step we would encourage trustees to get more familiar with the asset class. This guide has been written with that aim in mind, discussing the different sources of alternative income and the practical aspects trustees should be aware of. It should be a useful tool to initiate discussions both within the trustee board and with advisers and managers.

ANDREW STEPHENS

Head of Intermediated Institutional Clients, BlackRock

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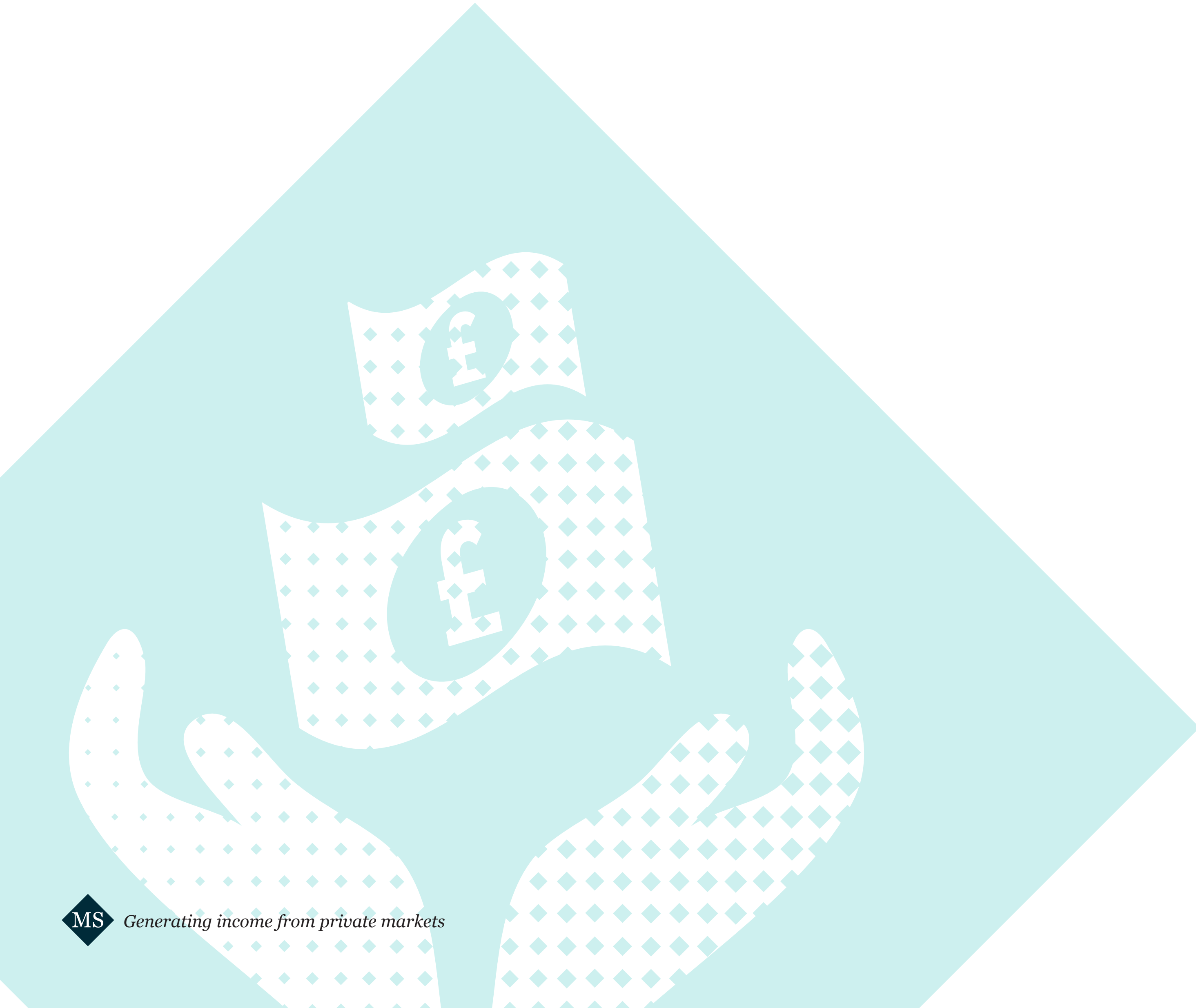


1 INTRODUCTION

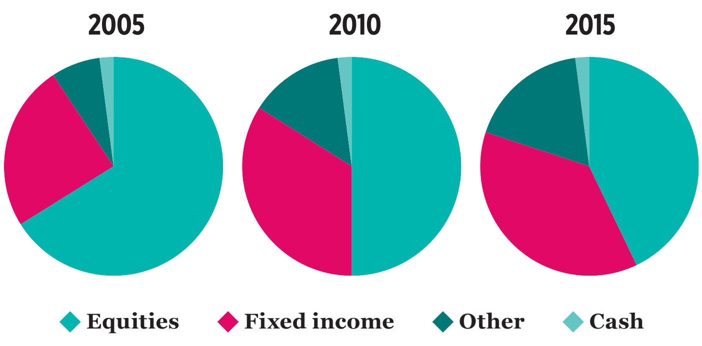
BRIDGING THE GAP...

DESPITE GENERALLY STRONG ASSET RETURNS SINCE THE FINANCIAL CRISIS IN 2009, THE AGGREGATE DEFICIT OF UK DEFINED BENEFIT SCHEMES HAS CONTINUED TO INCREASE, ACCORDING TO THE PENSION PROTECTION FUND (PPF)[1].

In addition, it is likely in the near-to-medium term that we will see lower returns from growth assets, lower yields across the board and increased volatility in an environment of modest economic growth expectations and elevated valuations. Meanwhile, many pension schemes are facing the prospect of pension payments to retired members exceeding contributions and investment income.

With traditional equity-bond portfolios unlikely to deliver the required return, other options are needed. Most schemes have responded to this challenge by diversifying, moving directly or indirectly into alternative assets. According to consultancy Willis Towers Watson, the average allocation to 'other' asset classes rose to 18 per cent in 2015, more than double the 7 per cent allocation 10 years ago (see Figure 1). In parallel, some schemes have hedged a considerable part of their interest rate risk through increased holdings of gilts and other suitable fixed income instruments.

Figure 1: Major shifts in the average UK pension portfolio



Source: Willis Towers Watson, Global Pensions Asset Study 2016.

However, while both these steps are important for managing risk, they are unlikely to be sufficient to close the funding gap and meet increased cash flow demands over the coming years.

1 Source: Pension Protection Fund, August 2016

...THROUGH ALTERNATIVE INCOME ASSETS

ONE ANSWER COULD BE ALTERNATIVE SOURCES OF INCOME, WHICH ARE MOSTLY FOUND IN PRIVATE MARKETS.

Although some indices are available, it has been in the more illiquid, actively-managed strategies where investors have found more consistent sources of yield. We go into more detail on these alternative income assets in sections 2 and 3, but in general they display one or more of the following characteristics:

- secure long-term cash flows
- higher yields relative to UK gilts
- inflation protection
- portfolio diversification

These private assets were once the purview of banks, but the financial crisis has been a game-changer as regulatory action has subsequently forced banks to scale back their lending. Consequently, a wide range of opportunities are now available to pension schemes (see Figure 2), which they can access via a direct, multi-manager or hybrid approach.

Figure 2: Major types of private market assets with income potential

	INFRASTRUCTURE DEBT	RENEWABLE INCOME	REAL ESTATE DEBT	LONG LEASE PROPERTY	STRATEGIC INCOME
Description	Predictable cash flows from long-term contracts	Portfolio of operating power projects	Senior real estate debt across various sectors	Portfolio of commercial real estate	Other investments that meet alternative income criteria
Target yield	3-5%	6-8%	4-6%	4-6%	5-8%
Weighted average cash flow tenor*	8-12 years	20-25 years	4-8 years	+25 years	4-8 years
Inflation linkage	Implicit; floating rates	Explicit; power purchase agreement tariffs	Implicit; floating rates	Explicit; lease payment resets	Implicit; floating rates

*** Tenor refers to the time left for repayment of loans or contracts**

However, investing in private markets means accepting lower liquidity and higher complexity; but provided the portfolio is appropriately structured, there is the potential to secure long-term income and increase diversification at a time when both are hard to come by.

This guide will examine how we define alternative income assets, explain why UK defined benefit pension schemes could benefit from a meaningful allocation, and outline the best approach to build an alternative income portfolio.

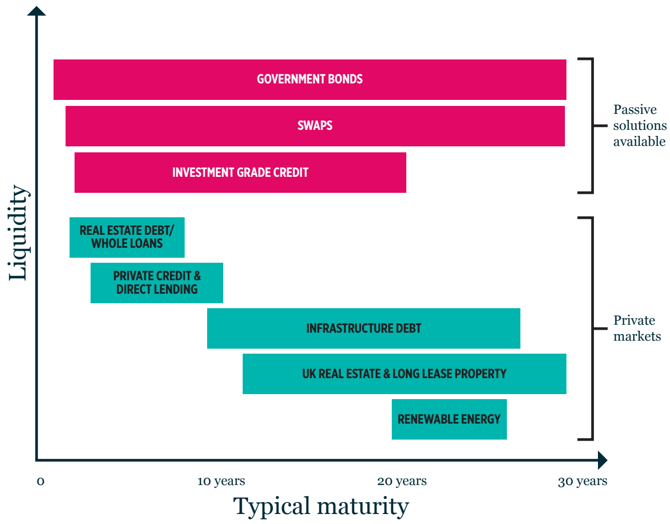
2
WHAT IS AN ALTERNATIVE INCOME ASSET?

IN THIS GUIDE WE REFER TO THESE TYPES OF ASSET AS 'ALTERNATIVE INCOME', BUT SOMETIMES THEY ARE ALSO CALLED 'PRIVATE MARKET INCOME', 'ILLIQUID INCOME' OR 'SECURE INCOME'.

In general, they all refer to a broad category of income-oriented private market or unlisted assets that can be used to help meet pension liabilities. While diverse, they share a number of common characteristics.

Illiquidity – Private market assets are relatively opaque and simply less actively traded than those on public markets. Transaction costs are higher and investors typically buy and hold assets for the long term. Figure 3 below highlights the differences in liquidity, or the extent to which an asset can be bought or sold quickly with little or no loss in value.

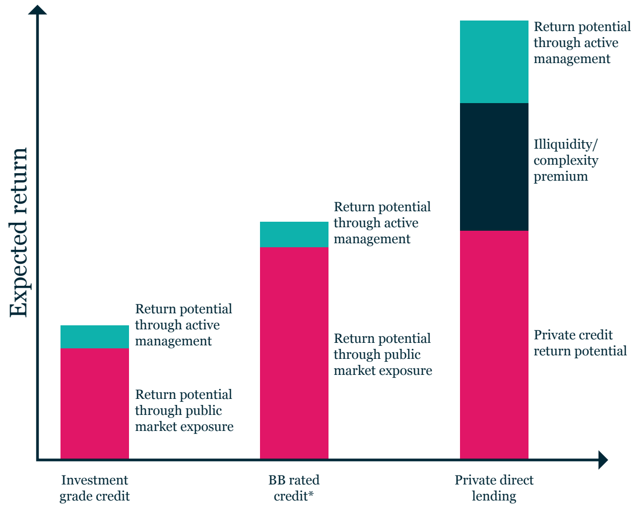
Figure 3: Liquidity across a range of assets available for liability management



Source: BlackRock. For illustrative purposes only

The trade-off for lower liquidity is that investors are rewarded with a premium relative to liquid credit assets of equivalent quality. This premium is typically dominated by the additional compensation that investors demand for taking illiquidity and complexity risk when investing in alternative income. Figure 4 illustrates this point by comparing the different potential return components in private direct lending, relative to public market equivalents.

Figure 4: Return potential of private direct lending vs. public market equivalents



Source: BlackRock. For illustrative purposes only
*** BB rated credit is two notches below the minimum credit rating requirement (BBB-) to qualify as investment grade standard credit.**

Security – The income streams are secured by underlying assets, which in many instances are physical in nature such as property or infrastructure.

Valuation – The difficulty in assessing true value is another attribute that separates these assets from their listed equivalents. Comparable investments are often difficult to find, meaning more work and expertise is required to establish an intrinsic valuation.

Lack of transparency – Private assets are not publicly traded. As a result, access to information can be severely limited. For example, some private assets may only be priced quarterly with a three-month lag. Investors therefore need to have in-depth knowledge of the market segment in which they operate with access to the required information.

Sourcing – Finding the appropriate investment is not straightforward. Access to investment opportunities can come through an auction or a discreet, direct approach, depending on investors' relationships and ability to finance transactions.

Structuring and negotiation – Custom structures and security features are more widespread in privately negotiated transactions, and pricing is more likely to be impacted by non-economic factors, such as time pressures to complete a deal.

Leverage – The levels of gearing and debt covenants in place to protect bondholders are more varied relative to public markets.

In conclusion, private market assets do have some drawbacks – mainly that they are less liquid and more complex relative to public markets, but that's also what makes them more rewarding, especially in the current low-yielding environment. As detailed in the next section, pension schemes can take advantage of their long investment horizon to invest in these alternative income assets.

3
WHY INVEST IN THESE ASSETS?

ATTRACTIVE ATTRIBUTES

ALTERNATIVE INCOME ASSETS OFFER A NUMBER OF ATTRIBUTES THAT MAY BE ATTRACTIVE TO PENSION SCHEMES:

SECURE LONG-TERM CASH FLOWS

Alternative income assets aim to provide predictable cash flows over long time horizons. The cash flows are secured against underlying assets.

HIGHER YIELDS

Alternative income assets have higher credit risk than government bonds and typically require a lock-up period. To compensate them for bearing credit risk and a longer investment horizon, investors should demand higher returns.

INFLATION PROTECTION

Alternative income assets may help to provide protection against the effect of inflation on liabilities.

DIVERSIFICATION

Alternative income assets have a low correlation to equities and bonds, which creates significant diversification benefits and may help reduce risk in a portfolio.

CHALLENGES THEY CAN HELP ADDRESS

THESE ATTRIBUTES HAVE BEEN PARTICULARLY ATTRACTIVE TO PENSION SCHEMES GIVEN THE THEMES BELOW.

Lower returns for longer

The persistent decline in yields is particularly problematic and adds to an already difficult funding picture. The returns and cash flows generated by traditional liquid assets used for liability matching[2], such as long-dated nominal and index-linked government bonds, swaps and investment grade debt, have already declined substantially and are forecasted to remain lower for many years to come.

Greater cash flow needs

Pension schemes' need for income is increasing. Many are maturing and cash flows are turning negative as payments to pensioners outweigh inflows from sponsoring employers and active members. Trustees could draw down some of the income received from their equity and bond allocations, or start selling assets. However, research has shown that reinvesting equity dividends can significantly improve the overall level of return from a portfolio, while selling assets to meet pension payments may not be appropriate depending on characteristics such as the maturity of the scheme.

Growing funding gap

Strong asset returns since 2009 have not led to improved funding levels for UK defined benefit pension schemes. According to the PPF, 84 per cent of schemes were in deficit at the end of August 2016, an increase of 6 percentage points from a year ago[3]. The aggregate deficit of the 5,945 schemes tracked by the PPF is also rising. Therefore a typical scheme faces considerable risk in funding outcomes and a long potential time horizon to reach fully-funded status; further action is clearly needed. The options are to review the investment strategy of the pension scheme, lengthen the target time horizon to get to full funding, or negotiate increased contributions from the sponsoring employer.

HARVESTING THE ILLIQUIDITY AND COMPLEXITY PREMIUM

MANY PENSION SCHEMES TEND TO INVEST MOST OF THEIR ASSETS IN RELATIVELY LIQUID STRATEGIES, YET THEIR LIABILITIES ARE VERY LONG-TERM IN NATURE.

In doing so, they could be giving up the potential additional reward on offer for those investors who are willing to commit capital for a longer period. Here is where private market assets can provide pension schemes with an opportunity to access assets with similar characteristics to their liabilities, but that also potentially generate higher returns than traditional matching assets such as gilts and corporate bonds.

A suitable allocation to alternative income assets will depend on a range of factors including the overall maturity and liquidity profile of the scheme as well as the trustees' risk appetite.

2 The matching of liabilities is part of the liability-driven investment philosophy, which aims to help defined benefit pension schemes establish a risk framework from which they can measure investment risk and set investment strategy.

3 Source: Pension Protection Fund, August 2016

4
TYPES OF ALTERNATIVE INCOME ASSETS

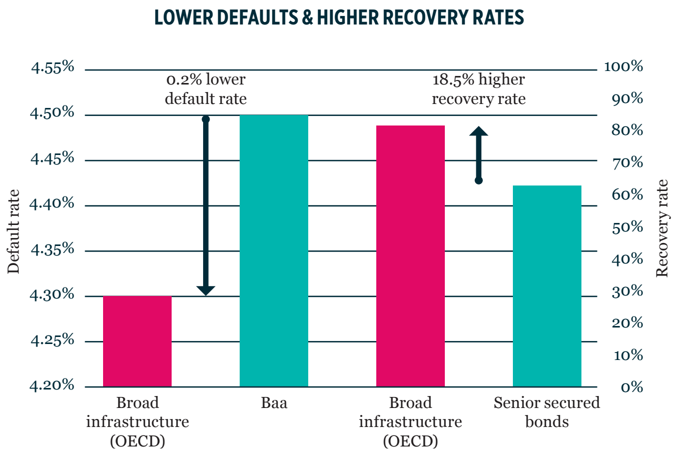
WE DISCUSSED IN SECTIONS 2 AND 3 THE COMMON CHARACTERISTICS THAT DISTINGUISH ALTERNATIVE INCOME ASSETS FROM TRADITIONAL LIABILITY MATCHING ASSETS IN PUBLIC MARKETS. HOWEVER, JUST AS THERE ARE DIFFERENCES ACROSS AND WITHIN PUBLIC MARKET ASSETS, SO TOO ARE THERE DIFFERENCES BETWEEN TYPES OF ALTERNATIVE INCOME ASSETS.

These differences can enable trustees to diversify sources of risk and return by allocating across different sub-asset classes and sectors. Here we will discuss five alternative income categories in more detail.

A) INFRASTRUCTURE DEBT

STANDARD & POOR'S INDICATED IN A 2015 REPORT[4] THAT THE UK HAD A £60 BILLION INFRASTRUCTURE INVESTMENT DEFICIT.

Figure 5: Unique risk position



Sources: 1) Moody's Default and Recovery Rates for Project Finance Bank Loans, 1983-2013 Addendum, as of September 2015. 2) Moody's Annual Default Study: Corporate Default and Recovery Rates, 1920-2013, as of February 2014.

According to the National Infrastructure Plan, the UK Government has committed to public capital investment of over £100 billion by 2020-2021. This is dwarfed by around £69 trillion of infrastructure investment that will be needed globally in the coming 15 years[5] in areas such as transport and energy. With traditional providers of capital such as banks constrained by stricter regulatory rules, there is an opportunity for pension schemes to lend to companies that are building and running these assets, either directly or through a specialist investment team.

The key characteristic of infrastructure debt is that capital and cash flows are secured on essential real assets. The interest payments received can be fixed or floating and may be explicitly linked to inflation.

Projects will frequently involve utility or public sector counterparties that may benefit from natural or regulated monopolies. The nature of these companies or organisations can shelter them from economic downturns, potentially offering diversification to traditional asset classes. This also means that default and recovery rates compare well to similarly rated corporate bonds (see Figure 5).

Key risks to consider

Investing in infrastructure debt requires a high level of expertise and industry knowledge, with a multitude of different contracts, debt covenants and risks to be considered. A wide dispersion in pricing can also exist between transactions. In the current low interest rate environment, more investors are turning to infrastructure debt to find yield, leading to more competition and potentially higher prices for deals. As a result, working in partnership with seasoned experts in the field is crucial. They can help ensure that the covenants appropriately protect investors and that the relative value is attractive enough to justify the lower liquidity.

4 Standard & Poor's Ratings Services: *Global infrastructure investment: timing is everything (and now is the time)*, January 2015.

5 *Driving sustainable development through better infrastructure: key elements of a transformation program*, Bhattacharya, Oppenheim, Stern, July 2015.

B) RENEWABLE INCOME

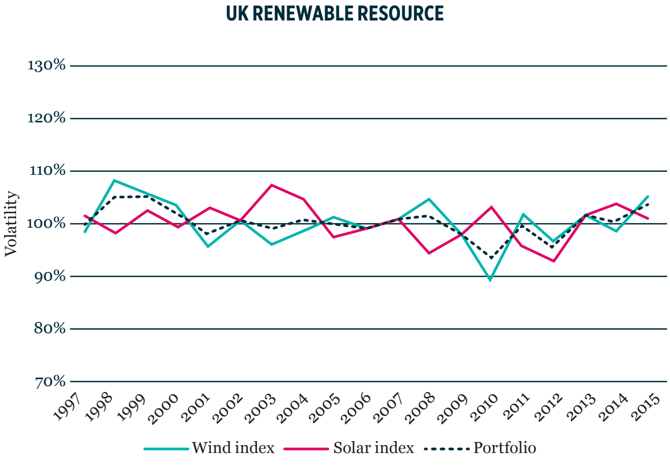
THE GREATER GLOBAL REGULATORY EMPHASIS ON RENEWABLE ENERGY, COUPLED WITH THE TECHNOLOGICAL ADVANCES AND COST IMPROVEMENTS RELATIVE TO FOSSIL FUELS, OFFERS THE OPPORTUNITY TO BUILD AN ATTRACTIVE PORTFOLIO OF RENEWABLE PROJECTS WITH STABLE, LONG-TERM INCOME STREAMS.

Renewable energy assets can be broadly categorised into:

Solar

There is an increasing emphasis on solar power. It is for instance a significant part of the European Union's energy mix and this sector has seen a dramatic reduction in costs, making it more competitive with other low-carbon electricity sources.

Figure 6: Wind and solar power provide stable and uncorrelated income over the long term



Sources: GL Garrad Hassan and Everoze (April 2016)
Note: Portfolio based on 70% Wind and 30% solar

Offshore wind

Offshore wind is one of the most scalable renewable energy technologies, with the European Union the global leader in terms of installed capacity and projected growth.

Onshore wind

Onshore wind is the most established and cost-effective large-scale renewable energy technology. A material additional build-out is expected in the period up to 2020, particularly in Europe where policymakers have introduced '20-20-20' targets for its energy sector, focusing on security of supply, competitiveness and sustainability. The '20-20-20' target refers to a 20 per cent reduction in CO_2 emissions relative to 1990, 20 per cent of energy consumption being sourced from renewables and a 20 per cent increase in energy efficiency by 2020.

An added benefit is that the income produced from wind and solar power assets tends to have low long-term annual variability. This can be reduced further by combining sectors into one portfolio (Figure 6). Renewable assets also offer implicit inflation protection, but some contracts will offer explicit protection. Separately, an allocation to this asset class can also help investors meet environmental and social goals.

Key risks to consider

While continued cost improvements and advances in technology bode well for the future of this sector, there are important risks to be aware of. Regulatory risk is a key consideration as government subsidies can be reduced or reversed with limited notice. Each deal will also have specific risks that vary across geographical locations and regulatory environments. Most UK pension schemes, however, are likely to focus on the lower-risk developed markets such as the UK, continental Europe and the US. Although the speed to market of wind and solar farms is half that of traditional gas- and coal-fired power plants, there is still initial development risk associated when investing at the early stages of development, meaning a high level of expertise and industry knowledge is required. Finally, low oil and gas prices could put a drag on current market power prices. However, what matters is the long-term structural change in the energy market and the technological advances that make renewables increasingly competitive.

C) REAL ESTATE DEBT

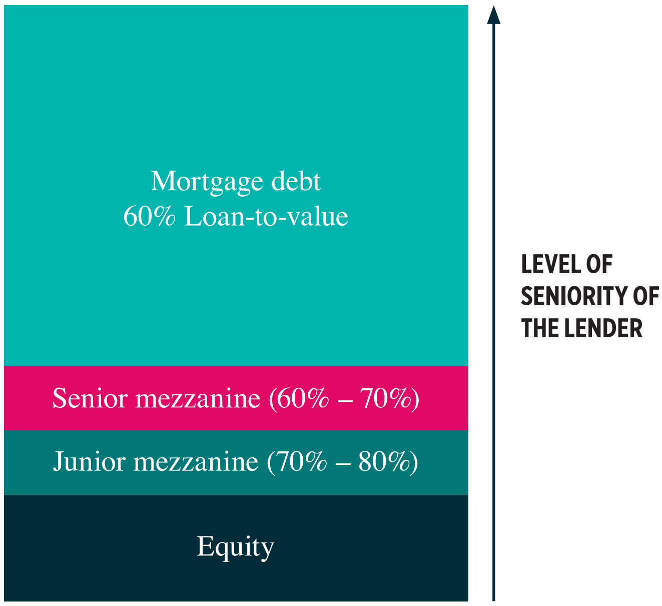
THE COMMERCIAL PROPERTY INDUSTRY IS VITALLY IMPORTANT TO DEVELOPED ECONOMIES SUCH AS THE UK.

Investors can benefit from the resulting return potential, whether it is through regular income or through increases in value. Specifically, for pension schemes seeking recurring income to help meet pension payments, commercial real estate debt offers an attractive alternative to traditional fixed income. It comprises different types of borrowing secured by properties such as offices and retail assets that in many cases have a long history of producing stable cash flows. As such, real estate debt could have a role to play in a diversified portfolio, complementing other income-generating assets.

Banks were previously big providers of capital in this space, but regulatory and capital constraints again mean that they are reducing their lending. As the debt overhang of the pre-crisis years is coming to an end, borrowers are therefore looking for alternative sources of capital, creating an opportunity for pension schemes to fill the gap.

The bespoke nature of real estate debt projects can be particularly appealing to experienced investors as it allows them to optimise their exposures to the stable contractual cash flows that underpin the asset class. To a degree, they are also insulated by the equity capital that is invested in the property. If equity makes up a quarter of the capital structure of a deal, then that asset would need to lose 25 per cent of its value before that investment is subject to a loss (see Figure 7 for an example capital profile of a real estate deal).

Figure 7: Capital profile of an example real estate deal



Source: BlackRock. For illustrative purposes only

Key risks to consider

The varied nature of the asset class does mean that each investment opportunity needs to be analysed on its own merits. Questions to consider include: have the property investors been active participants in the market throughout different cycles? What is the loan-to-value (LTV) ratio? How much debt have they already incurred? Is the business plan well thought out? What are the covenants in place to give bondholders protection?

D) LONG LEASE PROPERTY

ON THE EQUITY SIDE, REAL ESTATE CAN ALSO OFFER INVESTORS AN ATTRACTIVE YIELD IN THE CURRENT LOW-INTEREST-RATE ENVIRONMENT.

Long lease property is a real estate strategy that takes a lower risk income-focused approach, relative to a traditional core real estate investment strategy that relies on capital growth as well as rental income for its returns.

A typical long lease property, such as a supermarket or petrol station, is let for in excess of 20 years and benefits from regular contractual uplifts that are often linked to inflation, with all maintenance costs being the responsibility of the tenant. The focus on regular income means returns are less volatile compared to the wider real estate market, while the regular inflation-linked cash flows can also help schemes meet pension payments.

Further diversification within the asset class can be gained by selecting a range of different locations, sectors and tenants. Doing so means it is possible to benefit from the supply and demand dynamics of different industries and regions.

Key risks to consider

As with other alternative income assets, rigorous due diligence is required. In this instance, particular attention should be paid to understanding the tenant, their credit risk and the outlook for their business in the current environment. There is also exposure to implicit economic risk as property and rental values are linked to the strength of the local and wider economy. Real estate is not a very liquid asset class and investors should only consider it as a long-term investment. Should assets need to be sold, this may take time and will depend on prevailing market conditions. Risk can be mitigated through careful portfolio construction and diversification.

E) STRATEGIC INCOME

SOME NON-LISTED INVESTMENTS DO NOT FIT INTO ANY OF THE ASSET CATEGORIES OUTLINED ABOVE, BUT STILL PROVIDE AT LEAST ONE OF THE ATTRACTIVE INCOME-FOCUSED FEATURES: LONG-TERM CASH FLOWS; A PREMIUM OVER GILTS; AND INFLATION PROTECTION.

Because of their esoteric nature they could provide further diversification benefits. Examples include buy-to-let mortgages and private loans to midsize companies. Again, banks have reduced lending to midsize companies in an effort to shrink their balance sheets and comply with new post-crisis regulations, opening up these channels for institutional investors. Many larger pension schemes are already investing in some of these segments.

Key risks to consider

The risks will vary depending on the investment and success requires an in-depth understanding of different assets and markets, the ability to source deals that are attractive from a credit and return perspective, and the experience and know-how to manage the associated risks. For example, analysing the credit risk of a loan to a midsize company requires a very specific skillset and dedicated resources. However, a well-managed portfolio could perform better than equivalent, liquid credit asset classes. In fact, figures from the ratings agency Standard & Poor's[6] show that typical recovery rates on European mid-market loans exceed those for syndicated bank loans and high yield bonds[7].

In the next section we consider in more detail how to build an alternative income portfolio.

6 S&P 2014 *European Empirical and Recovery Rating Performance Update*, covering period 2003-2014.
7 Bonds that have been given a rating of BB+ or lower by the main rating agencies.

5
BUILDING AN ALTERNATIVE INCOME PORTFOLIO

UNLIKE TRADITIONAL STOCKS AND BONDS, IMPLEMENTING AN ALTERNATIVE INCOME PORTFOLIO IS NOT SIMPLY A CASE OF DETERMINING WHAT EXPOSURE IS NEEDED, AND THEN BUYING AN INDEX OR HIRING AN ACTIVE MANAGER TO OUTPERFORM A BENCHMARK.

Private assets take time to source, structure and negotiate and returns have varying underlying risk factors. This allows for more diversified sources of return, but also means there are more ways for things to go wrong.

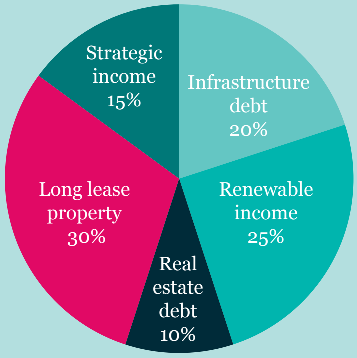
To get the most out of their alternative income strategy, investors need to look beyond asset class categories to understand the different risk-return trade-offs and how they come together in the overall portfolio. Then they need to understand the different options available to implement the strategy, whether by going direct, through a fund-of-funds, or an outcome-oriented hybrid approach. So what are the key principles to bear in mind?

WHAT IS THE DESIRED OUTCOME?

A pension scheme could have a number of different investment goals, whether it be portfolio diversification, matching cash flow liabilities, hedging inflation risk, boosting income or any combination thereof. The priority for each outcome may mean a different combination of assets.

In Figure 8, the example model portfolio is optimised to deliver income, with risks diversified across strategies and asset classes.

Figure 8: Illustrative alternative income portfolio



Optimal income

The model portfolio in Figure 8 was created through an iterative optimisation process that incorporates current and long-term market insights such as yield and deal flow. The resulting asset allocation is expected to generate a mid-single digit annual yield and a high degree of inflation-linkage from contractual cash flows of an average length of 10 years.

Source: BlackRock.

STRESS TESTING

When it comes to establishing a deeper understanding of risk, stress testing can be key. For example, how much illiquidity risk can the total portfolio tolerate under various scenarios? If interest rates rise faster than expected, or fall further, how will rental yields perform? This will help inform the appropriate allocation to private assets.

ACTIVE VS. PASSIVE

The investment landscape over the last two decades has been marked by a move from active to passive management in most traditional asset classes. While there are index strategies that track the underlying returns of select private market assets, including core real estate and core infrastructure, a more general passive solution for private markets does not yet exist.

Another consideration when deciding between public and private markets is whether the pension scheme is doubling up on risk exposures. A pension scheme may already be exposed to energy prices, for example, through its equity strategy. Careful analysis is required to determine whether to access these risk premiums through public or private markets.

ACCESS

If the decision is to access private markets, then trustees also need to consider how to access the appropriate alternative income opportunities:

1) Direct, or segregated, investment

This allows for the highest degree of investment control, but requires significant scale in terms of capital, resource and investment expertise. The majority of pension schemes lack the governance requirements to pursue this option, even if they have sufficient assets to build a diversified portfolio of direct investments.

2) Multi-manager

A common method is to combine 'best of breed' managers from a range of asset classes and strategies into a single portfolio. The benefit of this approach is simplicity and a low impact on the governance budget. Although intuitively appealing, this approach can be costly and the deployment of capital (frequency, timing, amounts) across different managers can be complex.

3) Hybrid

A flexible, outcome-oriented approach that combines direct investment where appropriate and fund allocations when it is deemed most efficient. Ideally this should be controlled and managed, either internally or externally, 'under one roof'.

A pension scheme's size, governance budget and access to resources should indicate which of the above options is the most appropriate. Once the method of access has been decided, schemes and their advisers need to assess how the alternative income strategy fits in with the overall portfolio. The next step is careful implementation.

IMPLEMENTATION

The solution should be conceived and designed to achieve the objectives of the pension scheme. A strong sourcing network is necessary to find the best opportunities available and value them appropriately, relative to similar public market assets. The appropriate processes need to be in place to complete the deals and monitor the investments. Finally, the trustee board should be comfortable that the reporting provided is frequent and transparent enough to allow them to exercise their fiduciary duties.

6
QUESTIONS TO ASK

DUE DILIGENCE PLAYS A MORE IMPORTANT ROLE WHEN INVESTING IN REAL ASSETS RELATIVE TO TRADITIONAL STOCKS AND BONDS, EVEN IF INVESTORS CHOOSE TO ALLOCATE TO EXTERNAL MANAGEMENT. THE IDIOSYNCRATIC NATURE OF PRIVATE MARKETS, ALONG WITH THE LONG-TERM COMMITMENTS REQUIRED, CALLS FOR A SPECIALISED SET OF SKILLS AND SIGNIFICANT RESOURCES TO FIND AND NEGOTIATE DEALS, EXECUTE THEM AND MONITOR THE INVESTMENTS.

Here are some questions to ask, whether taking a direct, multi-manager or hybrid approach.

WHAT RESOURCES HAVE YOU DEVOTED TO PRIVATE MARKET INVESTMENTS?

There is a huge amount of effort that goes into sourcing, evaluating and structuring private deals. Investing in private assets is five times more resource intensive than investing in public markets[8]. You, your consultant and/or asset manager should allocate the appropriate resources across the full range of private market assets and related supporting services, such as adequate legal expertise. Other important questions include how would the portfolio be impacted if a key individual or investment team left?

HOW DO YOU FIND AND NEGOTIATE DEALS?

It is extremely important to have extensive relationships with third parties. This requires a long-term commitment to the market to access the best opportunities. Is your investment partner's reach deep enough to gain access to the best deals, or will they only be able to invest through highly syndicated – i.e. popular and hence potentially pricey – transactions? Having more deals from which to choose increases the likelihood that each transaction will meet investors' needs.

WHAT IS THE DUE DILIGENCE PROCESS WHEN SELECTING AND EXECUTING AN INVESTMENT?

The ability to price an investment appropriately is integral to succeeding in private markets, as by definition they are not publicly traded and are hence difficult to value. To that end, does your investment partner have the skill and expertise in areas such as fixed income, equities and property to fully assess a given deal? What about the relevant competencies to mitigate credit risk satisfactorily?

8 Source: BlackRock, May 2016. Data from public filings and company websites of four leading alternative investment managers, with assets under management between US$95 billion and US$350 billion, and four leading traditional asset managers, with AUM between US$850 billion and US$1.5 trillion.

HOW CAN RISK BE MANAGED?

Investors should consider how correlated their private asset investments are to the overall portfolio, especially as diversification is one of the main reasons for investing in private markets. It is therefore crucial to monitor any unintended concentration risk that may exist. Private market managers often take more concentrated positions relative to their public market competitors, partly due to the lumpy nature of the deals themselves. In addition, when one manager sees an opportunity in one asset class or industry, others may follow.

For example, unintended concentrated risk in the energy sector could exist if a pension portfolio contains the following:

- Distressed energy exploration and production companies within the private equity strategy
- Opportunistic real estate investments in an oil-dependent economy within the property allocation
- Debt from an oil-field services company within the private credit portfolio.

While each investment case is reasonable, the investor now has an outsized bet on the energy sector.

HOW DO YOU MONITOR PRIVATE ASSETS IN YOUR PORTFOLIO?

Since private assets are long-term investments that cannot always be sold easily, ongoing monitoring is vital and requires advanced planning across the investment process. If opting for a multi-manager approach, will you have adequate transaction level transparency and deal flow visibility? What reporting information will be needed to enable appropriate risk management after a deal is completed?

Operationally, a different skillset may also be required to help turn around a business if needed. But even under the most rigorous monitoring system, a business could still fail. So in-house restructuring expertise to maximise recovery on those investments is therefore also critical.

7 SUMMARY

IN AN ENVIRONMENT IN WHICH INVESTORS CAN NO LONGER DEPEND ON TRADITIONAL ASSETS TO DELIVER ON THEIR INVESTMENT TARGETS, THE INCOME POTENTIAL FROM PRIVATE ASSETS COULD OFFER MUCH-NEEDED PORTFOLIO STABILITY. THE YIELD FROM ALTERNATIVE SOURCES IN PRIVATE MARKETS CAN DELIVER PREDICTABLE AND LONG-TERM CASH FLOWS THAT ARE SECURED BY UNDERLYING ASSETS AND ARE OFTEN LINKED TO INFLATION.

Schemes will need to forego some liquidity, but what they gain is a healthier premium relative to liquid credit assets of equivalent quality. From a strategic perspective, alternative income also offers added portfolio diversification and therefore the potential for meaningful risk reduction.

The challenge is that these assets reside off the beaten track, and implementation requires an array of specialist resources to assess, execute and monitor investments. Proprietary knowledge, rigorous risk management systems and operational capabilities are all crucial elements to deploy capital effectively. For smaller investors with a modest-sized portfolio, this task is unlikely to be cost-effective. So it's important to find the right method to access alternative income; and perhaps more importantly, the right partners.

There is a wide range of illiquid assets under the alternative income umbrella that could meet investment targets, including infrastructure and real estate debt, renewable energy and UK long lease property. While they share some common characteristics, the drivers of their returns are materially different. Even within asset classes, projects vary substantially. So building an alternative income portfolio requires a careful balancing between the underlying risks of individual projects and how they fit into the overall investment portfolio. Specific needs of the investor, such as their liquidity budget, risk tolerance and cash flow requirements, should all be taken into account.

Investing in private markets is a long-term commitment. Nevertheless, pension schemes need to look for new and different forms of income in a compressed return environment. What's more, their long-term investment horizon means that they are uniquely positioned to exploit the structural changes occurring in private markets. Even schemes looking at an insurance solution may find that an appropriate allocation may speed up the journey to buy-out.

In summary, it pays for trustees to become familiar with these alternative sources of income and how they can be put to work to help meet funding goals.

NOTES

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