Alternative Investments – institutional investors' competitive edge

With the increased competition, how will institutional investors exploit their competitive edge to access non-traditional investments?

At the basis of this paper lies a simple, inherent question; what actually is the competitive edge of institutional investors? The typical answer to this question is time. That is, given the long-term nature of the objectives that institutional investors are (usually) looking to deliver against, the institutional investor can afford to take longer-term views and access longer-term risk premia (in particular, illiquidity risk) than other investors in market. By our estimation, in some areas this risk premia can be worth up to 2-3% p.a. Enjoying this much additional income for investing into long-term assets that are more aligned to the timeframe of your objectives (while also allowing for other benefits, such as being more aligned to a sustainability mind-set) is a large advantage for the institutional investor.

At the same time, it is generally accepted that institutional investors have a competitive disadvantage when it comes to execution. Building internal capability is very difficult for a vast majority of institutional investors (by number) having the scale to build a team and program of a size to justify an execution capability is not practical. Further, often the more problematic aspect is placing the transactional requirements of execution (governance around decision making, team skill set and remuneration and execution risk) within an institutional investing organisational framework that generally is not set up to accommodate these demands.

Based on our experience, we do not believe that a lack of execution capability in alternative investments should concern most institutional investors. This is because a focused execution capability reduces investment flexibility, and **investment flexibility is the key competitive edge that institutional investors enjoy**. The nature of alternative investments means that best-practice execution capability is by definition narrow. As an example; the skills required to source and manage solar renewable assets are very different to those required to manage a portfolio of direct lending assets. As an institutional investor your sole focus is on accessing assets with return streams that assist in achieving your objectives. Creating structures that focus on delivering this singular objective is crucial to delivering on these goals. The flexibility to do this through accessing the best assets (through the best execution partners) from right across the alternative asset spectrum maximises the chances of success.

And the ability to have a long-term mind-set and be flexible in accessing assets is even more important in times of increased competition for assets. Significant capital has flown into alternative assets over recent periods. IJ Investor recently reported that fundraising in infrastructure in 2018 topped the $100bn mark; this from an asset class that didn't really exist outside of Australia 15 years ago. Similar stories can be weaved through the broader asset classes of real estate and illiquid credit. In many cases this has led to higher prices, slower deployment and/or strategy drift (Did we learn anything from 2005-2008?)[1]. In this environment, having the flexibility and timeframe to pick and choose your spots and finding those pockets where capital is sparse and best practice execution can add significant value, are critically important.

So how do institutional investors make the best use of this flexibility? There are three elements that are needed to optimise this competitive edge:

1. Decide what you want to achieve from your investments into alternative assets
2. Identify interesting areas that meet the strategic requirements
3. Access best practice execution

Figure 1. **Elements to optimise the competitive edge**

Decide what you want to achieve from your investments into alternative assets

One of the most interesting aspects of working in alternative assets is the breadth of the asset classes. A prime building let on a long-term lease in Frankfurt and a new-build hotel in a holiday resort in South East Asia are both real estate assets, but their risk profiles and what they offer to institutional investors' portfolios are substantially different. The same is true across infrastructure and illiquid credit, both within and across the various asset classes that constitute alternative assets.

This breadth makes alternative assets an incredibly fertile ground for institutional investors, no matter what their objectives (whether paying benefits for defined benefit schemes, growing pension pots for defined contribution superannuation schemes or managing risk and return in an endowment capacity) there are elements of the alternative asset space which can help in fulfilling their requirements.

However, the flip-side to this is that there is a universe of assets that don't necessarily add value versus what you are trying to achieve.

Institutional investors need laser focus. Understanding what alternative assets can help them achieve is critical to success and maximising value. This is particularly important given the illiquid nature of alternative assets.

While we would argue that the longer-term nature of institutional investor's objectives means that most can take on more illiquidity premia risk, there is a finite amount of illiquidity that any investor can take. Given this, it is doubly important to focus your alternative investments on those areas which provide the most benefit for meeting your strategic objectives.

A good example of this is the recent trend by many European Defined Benefit investors to focus on alternative assets that provide longterm, inflation-linked cashflows; these are often referred to as Secure Income Assets (or SIAs). As many European investors look to de-risk and focus more on how they will deliver the long-term inflation-linked cashflows required to meet their benefit promises, using alternative assets to provide a strong element of these requirements is growing rapidly in popularity.

[1] https://ijglobal.com/articles/138310/infra-fundraising-oops-we-did-it-again

Identify interesting areas that meet the strategic requirements

Are having a laser focus and identifying flexibility as a competitive edge inconsistent? No, they are indeed consistent. Laser focus is all around identifying the types of assets that are needed to meet your objective. In of itself it does not provide particular insight or competitive advantage, but it does allow an institutional investor a framework against which to determine the value of any type of investment. However, within this framework, giving yourself the maximum available opportunity set to meet these objectives is critically important.

This approach means moving away from allocating to traditional asset class boundaries such as real estate and infrastructure (which as described above may be unhelpful) and leads to a more holistic approach to allocating capital. The focus is on finding assets that deliver specific characteristics that an investor is looking to deliver. In the case of SIAs this focus is on finding assets that deliver the cashflow profile that meets the objectives; that the assets that deliver these characteristics (such as long lease property, ground rents, social infrastructure and renewables) usually sit within the broad definition of real estate and infrastructure is not a driver of the investment decision.

This approach is helpful at all times but is particularly helpful during periods of high competition. Defining investment objectives based on characteristics, rather than allocating capital within narrowly defined asset classes or strategy buckets, allows the institutional investor to pick and choose spots across a range of areas that help deliver a specific objective. This means that they have the ability to avoid those areas which are most competitive. Probably the best example of this within the SIA universe is senior infrastructure debt; due to significant investment in this area returns have been compressed significantly. A rigid asset class driven approach where an allocation to infrastructure debt had been agreed would lead to an investment in this area. However value can be generated by allocating to other parts of the SIA universe which offer similar cashflow characteristics but with better returns. This is not trying to disparage infrastructure debt; in a few years' time other parts of the SIA universe may be over-priced and it may be infrastructure debt that looks attractive. The key point is that an approach that allows you to take those relative value decisions adds value, and the institutional investor is well placed to implement such an approach.

Where this approach adds most value is where an institutional investor is willing to innovate.

Through a combination of research, insight, market contacts and a fair amount of luck, it is possible to find new areas of investment that are less exploited than those areas that have been tried and tested. And following detailed due diligence it is possible to invest in these areas with confidence in the risk profile together with the potential for greater returns and the ability to deploy capital quickly. Even in today's market where there is significant capital for alternative investments, there is the potential to find parts of the market where capital is scarce. Another example in the SIA space is investing in social housing for the homeless in the UK (see *Figure 2*). For various reasons this has traditionally not been an area which has accessed a significant amount of institutional investment. This means that those willing to invest in it today can generate an attractive risk-adjusted return while also generating significant community benefits by investing in this chronically under-invested but socially critical part of the market.

Figure 2. **Example investment made as part of the Willis Towers Watson secure income and multi-asset pooled fund solutions**

Social housing for the homeless

- Targeting an attractive and under-explored real estate sub-sector to deliver strong inflation-linked returns supported by the government
- Negotiated attractive fee schedule and fund terms to ensure robust investor governance rights
- Strong inflation-linked, government-supported returns delivering wider societal benefit in helping to address the UK homeless challenge

Target net return ILG[4] + 5%	**80,000 UK households in temporary accommodation**	**Expected distribution yield 5%**

This ability to identify the new and innovative idea is difficult; it takes skill and judgement as well as an ability to think and (then importantly) act in a contrarian way.

Governance needs to be sympathetic to the approach. However institutional investors have a real competitive advantage when it comes to accessing these types of ideas.

Access best practice execution

The way that the most successful institutional investors access execution has evolved over recent times. Rather than simply 'consuming' the offerings proposed by alternative investment managers, institutional investors are now engaging in areas where they identify skill to shape the products offered. This allows for institutional investors to help best practice execution partners to better understand what institutional investors require Institutional investors benefit by improving structures, terms and fees in the vehicles in which they invest, while best-in-class execution benefits by de-risking their fund-raising.

Again, this approach increases flexibility, particularly when institutional investors act in concert to increase the amount of capital and influence they are able to exert. In this way, institutional investors have the ability to access best-in-class execution across the broadest possible range of investment opportunities. The key is a) being able to identify the best-in-class execution and then b) convince them that the institutional investor(s) can deliver on what they have promised.

Willis Towers Watson and our clients have been investing in alternative assets in this way for the best part of a decade and have a long track record of working with managers to create new and innovative ways of accessing parts of the market previously untouched by institutional investors. We have found this track record is a virtuous circle. By working with managers to invest capital into new areas that deliver stronger returns, additional capital is able to be invested into new ideas increasing the attractiveness to best-in-class execution.

The ability for institutional investors to make the best use of the flexibility they enjoy will determine how successful they are with respect to investing in alternative assets. By focusing on what they are trying to achieve, identifying the best assets and strategies that help to meet these objectives and then working with the market to access the best-in-class execution capabilities that exist, institutional investors can make best use of the rich blend of assets that are available from alternative assets, while at the same time navigating away from those areas that demonstrate the pitfalls of excessive competition.

Further information

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