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Seeking returns in private markets and emerging markets in a disruptive era

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Amundi Investment Solutions

Trust must be earned

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Di Yaorusheng, Getty Images

Foreword

Public markets in the West are hitting their all-time highs. They are also undergoing de-equitisation, as share buy-backs continue apace and the IPO pipeline becomes more irregular. As a result, pension plans are turning the spotlight on new growth engines as they intensify their search for decent risk-adjusted returns, especially with the change of administration in the US.

This 2024 AMUNDI–CREATE survey – the eleventh in the current annual series – seeks to shed light on two broad sets of asset classes in which many pension plans have long been underweight: private markets and Asian emerging markets.

Both entered a new era with the recent rise of geopolitical risks and steep hikes in interest rates during 2022–23. Yet, both still potentially offer attractive risk-adjusted returns, by being structurally well placed to harvest what are seen as the more predictable sources of value creation from secular mega trends.

Against that backdrop, this survey highlights the factors that limited the allocations of survey respondents in the recent past and how new drivers are likely to raise them, as geopolitical risks reconfigure global supply chains and key central banks worldwide advance in the current rate-cutting cycle.

The survey also shows how dark clouds on the horizon can have silver linings that respondents are seeking to capitalise upon by expanding the traditional risk–return equation to include sustainability and liquidity.

More than ever, this extension involves pension plans striking a delicate balance between opportunity and caution: opportunity, because they need to remain invested to be able to meet their financial obligations to their members; caution, because capital conservation is a top priority as the majority of pension plans enter their run-off phase due to ageing demographics.

This enjoins their external asset managers to develop smarter ways of investing in order to meet their clients' needs in a radically changed investment environment, ushered in by the end of the cheap money policies of key central banks.

At Amundi Asset Management, we are grateful to Professor Amin Rajan for undertaking this impartial research that highlights the changing dynamics of private markets and Asian emerging markets and the criteria used by our clients to select their external asset managers in a changing era.

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Monica Defend

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Acknowledgements

"The real voyage of discovery is not in seeking new lands but seeing with new eyes."

Marcel Proust

Pension plans are acting on this advice as they transition to a new investment regime after a sharp break from the prolonged era of cheap money policies, freer markets and globalisation of trade and finance.

The disruptive forces are opening up new threats and opportunities, raising the question: where will the returns come from?

This is the subject of the 2024 annual pension survey in a research programme first started in 2014 by Amundi Asset Management and CREATE-Research. This year's survey turns the spotlight on two underinvested areas so far: private illiquid markets and Asian emerging markets.

My foremost thanks go to the 157 pension plans in thirteen key fund jurisdictions who participated in the survey. Their practical insights have shed light on the upsides and downsides of these markets with high risk–reward features.

Over the years, the participation of many of these respondents in previous surveys in the series have helped to create an impartial research platform whose outputs are widely used in the key pension markets worldwide.

I am also very grateful to Amundi Investment Solutions for sponsoring the publication of this report without influencing its findings in any way. Their arms-length involvement has helped to canvass a wide spectrum of views in the pension landscape so as to deliver an independent assessment of the future prospects of these two markets.

My grateful thanks also go to IPE for helping to conduct the survey and especially to its editor, Liam Kennedy, for his wise counsel and unstinting encouragement throughout the history of this research programme.

Last but not least, I would like to thank four colleagues at CREATE-Research: Anna Godden for desk research, Lisa Terrett for project management, Naz Rajan for data analysis and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors and omissions, I am solely responsible.

Amin Rajan

Amin Rajan

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1 Executive Summary

Introduction and aims

As pension investors transition to a new regime, one question has come to the fore: where will the returns come from?

The Great Moderation of the past 25 years was marked by stable economic growth, low interest rates and low inflation. They favoured 'set-and-forget' asset allocation. That was shattered by four recent cascading game changers: the severe monetary tightening by key central banks to tackle the inflation spike; worsening conflicts in the Middle East and Ukraine; the rise of populism in the West due to the cost-of-living crisis; and the US–China geopolitical rivalry fragmenting the intricate web of global supply chains. That integration is now seen as a source of risk and insecurity.

On the upside, however, this is also creating opportunities as capital markets adjust to the new regime. With public equity markets in the West flirting with their all-time highs, the search for good risk-adjusted returns is turning the spotlight on two sets of thus far underinvested asset classes.

"The global economy is being splintered by worsening relations between America and China. Relying on the typical cyclical playbook may be unwise."

An interview quote

The first set covers illiquid assets in private markets, benefiting from the recent surge of investment in strategic sectors like AI, defence, renewable energy and infrastructure. Private markets are increasingly seen as providing exposure to innovation while IPO activity remains sluggish, especially in Europe. As such, they are viewed as a most likely source of value creation for the foreseeable future.

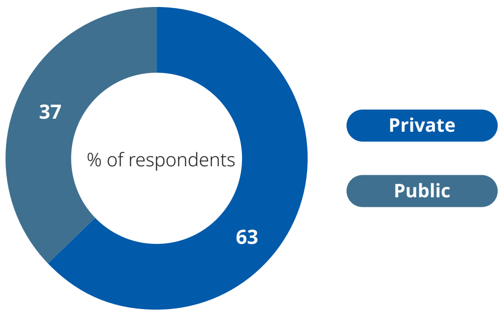
The other set covers Asian emerging market assets in the world's fastest growing region. It accounts for 46% of global GDP, 60% of the world's population and 60% of expected global growth through 2030, according to the IMF and the World Bank. The centre of gravity of the world economy is shifting towards this region, according to current narratives. Hungry for foreign capital to facilitate energy transition, they are also implementing investor-friendly reforms.

Hence, the 2024 Amundi–CREATE global pension survey has a twin focus on asset classes in private markets and Asian emerging markets. On a three-year forward view, it addresses five questions:

- what are pension plans' current allocations to these asset classes and how are they likely to change?
- which factors have constrained allocations so far and which ones will likely drive them in future?
- what specific investment benefits are being targeted and to what extent have expectations been met?
- how is the mix of components within each of the broad asset classes likely to change?
- which selection criteria will be used when awarding new mandates to external asset managers?

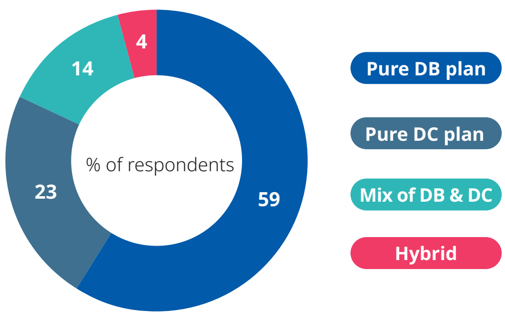
The survey involved 157 pension plans in 13 key jurisdictions, collectively managing €1.97tn of assets (see figures below). The survey results were bolstered by 30 structured interviews with senior decision makers from respondent organisations. The survey provided the breadth, with interviews adding depth and insight. The rest of this section presents the survey's highlights and key findings in two parts.

What sector does your pension plan cover?



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

What is the nature of your plan?



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Survey highlights

(% of pension plan respondents)

Private markets: Future increase in allocations and their key drivers

74%

Are currently invested in private market asset classes with varying degree of allocations

86%

Expect to be invested in three years' time

72%

Believe that new allocations will be driven by a heightened search for good risk-adjusted returns

54%

Expect further cuts in interest rates to facilitate the next wave of allocations

Private markets: Asset class and regional outlook over the next three years

55%

Expect to increase their allocations to private debt

49%

Expect to increase their allocations to private equity

71%

Cite North America as a source offering best returns

59%

Cite Europe as a source offering best returns

Asian emerging markets: Future increase in allocations and their key drivers

62%

Are currently invested in Asian emerging market asset classes with varying degree of allocations

76%

Expect to be invested in three years' time

74%

Perceive that new allocations will be driven by a heightened search for good risk-adjusted returns

61%

Expect the reconfiguring of supply chains in the region to enhance the prospect of better returns

Asian emerging markets: Asset class and regional outlook over the next three years

50%

Expect to increase their allocations to thematic funds covering renewables and high tech

48%

Expect to increase their allocations to hard currency debt

49%

Cite India as the most favoured nation for their new allocations

43%

Cite South Korea as the second most favoured nation for their new allocations

Part 1: Private markets

1. Private markets face improved prospects due to the current rate-cutting cycle

Currently, 74% of survey respondents have already allocated sums of varying proportions to private markets in total: 49% have allocations of up to 15% and the remaining 25% have above 15% (Figure 1.1). These investments are part of their strategic asset allocation (SAA).

On balance, the current levels of allocations owe less to these inherent constraints and more to steep and prolonged rate hikes in recent past.

The size of a respondent's portfolio allocation has varied directly with the size of their respective asset base. Those with a larger base have had the requisite governance structures, skill sets and time horizons to venture into illiquid assets.

The biggest allocations originate from the US, followed by Europe and Asia-Pacific. The US is also the favourite destination of these allocations, making it the epicentre of private markets. Europe is the next favourite centre.

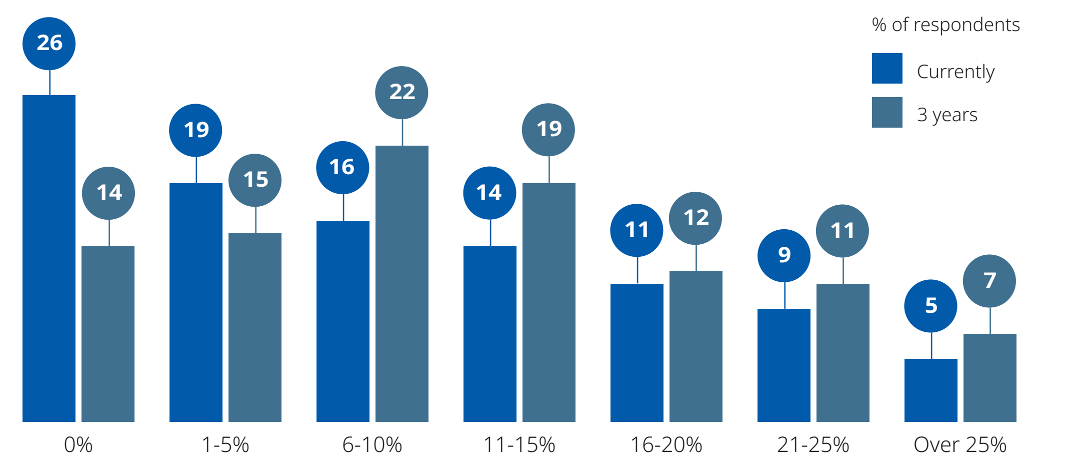
Thus far, the allocations have been constrained by many factors (see Section 2). Of these, the two key ones are external to private markets. One is rising geopolitical risks, which are hard to model and difficult to price. Another is the steep spikes in the benchmark US Federal funds rate from zero bound in 2020 to its 23-year high in 2023 that sparked a major reversal in asset values.

For private equity, that hit the IPO pipeline in volatile markets, making exits difficult for maturing funds. In private debt, higher rates jacked up the default rates and forced loan restructuring. In infrastructure and real estate, they raised funding costs and hit capital values.

Before then, there have also been other factors inherent to private market assets that had constrained allocations. High fees and charges top the list. This applies to the traditional 2-20 fee model in private equity, venture capital and, to a lesser extent, private debt. It reflects the fact that private assets need customised contracts that are harder to replicate and rely solely on active management, unlike their public market peers.

Other inherent constraints include opacity in the investment process and performance evaluation; high friction costs caused by premature exit; high dispersion in ultimate investment returns; and an all-time high level of 'dry powder' – sums allocated but not invested, waiting for opportunities to arise.

Figure 1.1 **What is the approximate share of all private market assets in your pension plan's total investment portfolio currently, and what will it be in three years' time?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"A growing share of global value creation takes place in private markets, and companies are also remaining private for longer."

"We are cautiously optimistic that things will be trending in a better direction once cuts in interest rates progress over the next 2-3 years."

On balance, the current levels of allocations owe less to these inherent constraints and more to steep and prolonged rate hikes in the recent past.

However, on a three-year forward view, our respondents expect the outlook to improve for private markets. The proportion of respondents investing in them is likely to rise from 74% to 86%, with rising shares in the asset base (Figure 1.1). For them, the price of going into private markets is only exceeded by the cost of staying out. Two sets of drivers are now in play (see Section 3).

On the external side, the search for good risk-adjusted returns tops the list of our respondents. With public equities flirting with their all-time highs, private markets are seen as a more credible option. Another key driver will be continuing cuts in interest rates started in 2024 by the main developed market central banks and most of the emerging market central banks, including China. Survey respondents expect the Fed funds rate to fall to 3.75% over the next two years. Fresh tailwinds will be reinforced by two further drivers: the ongoing de-equitisation that is shrinking the universe of public markets; and European regulators relaxing the liquidity rules and price caps in defined contributions pension plans.

The price of going into private markets is only exceeded by the cost of staying out.

These external drivers are expected to be bolstered by three drivers that are inherent to private markets. First, ever-more growth companies are coming to private markets and remaining private for longer. Second, fund covenants are offering more effective opportunities for engagement on environmental, social and governance issues (ESG). Third, secondary markets are evolving to offer liquidity in periods of financial stress.

2. Pension investors are becoming more demanding as the market environment has changed

For our respondents, the prospect of attractive returns remains the North Star of private markets, even though lifetime returns have varied between asset classes. The average for venture capital has been in the high upper teens, those in private equity and private debt have been in the low teens, and those in real estate and infrastructure have been in high single figures. Private debt, infrastructure and real estate have also had contractual 'pass through' links to inflation. Overall, in the entire private market portfolio, returns have been favourable but with wide dispersion.

On the upside, 28% say that overall returns have exceeded or far exceeded expectations (see Section 2). The highest returns have accrued to larger plans, who were either early adopters and/or have had a prominent brand and a big enough asset heft to co-invest directly in deals that avoided or minimised management charges and performance fees. On the downside, 32% say their returns have been below or well below expectations.

The remaining 40% say they have been on par with expectations: with a 'hurdle' rate of 8% that is roughly 2% higher (net of fees) than their public market returns.

Thus, the illiquidity premium has not been uniform. This problem has been more evident in Asia-Pacific.

Looking to the future, as Figure 1.2 shows, good risk-adjusted long-term returns remain the top targeted benefit (72%). The second is achieving a triple bottom line: doing well financially and doing good socially and environmentally (56%). Regulators in many jurisdictions enjoin pension plans to treat ESG investing as part of their fiduciary duty and report progress regularly. For example, sustainability is part of the AP funds' mandate from the government in Sweden. Most mandates are, hence, hardwired to use forward-looking data and credible proof points that ESG investing works in practice. In private equity and private debt, the targeted stewardship activities are more effective in view of the ownership structure and customised covenants, even though they require extra resources.

Yet another targeted benefit is better diversification. This is especially valued since the traditional 60:40 portfolio has struggled as inflation has taken off (47%). The final benefit is lower volatility as private market assets are not subject

Interview quotes

"Private markets are more suited to thematic investing with their abundance of pure play companies and customised mandates."

"We chase returns, not asset classes. In the near term, private assets will deliver superior risk-adjusted returns compared with public markets."

to mark-to-market accounting rules that transmit the volatility of public markets into pension portfolios and often cause large unwelcome deviations from their strategic benchmarks (42%).

For survey respondents, the current list of targeted benefits is the same as before. What has changed is the emphasis from quantity (investing in liquidity-fuelled markets) to quality (delivering sustainable returns based on intrinsic value). It's not enough that an increasingly larger share of global value creation is expected to occur in private markets. Extracting their intrinsic worth now matters much more with the end of unconventional policies of central banks.

Going forward, two shifts will likely mark a break from the previous approach that thrived in the era of abundant liquidity.

Going forward, two shifts will likely mark a break from the previous approach that thrived in the era of abundant liquidity.

First, investing will be a pragmatic blend of opportunity and caution. Whilst fear of missing juicy returns remains a powerful driver, capital conservation will become a key imperative for survey respondents. Both will require a delicate balancing act in pension portfolios, while unpredictable risks lurk in the background. This especially applies to potential vulnerabilities from growing interdependencies between private equity, private debt and real estate in cross-asset class deals.

Second, a significant proportion of the past returns on private equity and venture capital enjoyed by survey respondents have reportedly come from the expanding market multiples helped by favourable monetary tailwinds, more than from the intrinsic worth of the underlying assets. It is time, now, to enhance business excellence to expand operating leverage and the profit margins of the portfolio companies. The next wave of growth will have to be powered by harnessing the fundamentals of these assets in a forward-looking approach, marking a break from the past.

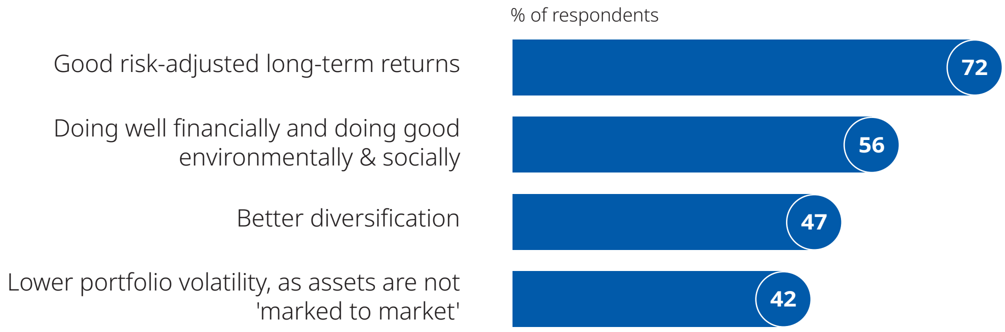
3. The future of private markets requires their general partners to sharpen their focus on value creation

The focus on quality is vital for private market assets to sustain and enhance their current distinctiveness in the investment universe.

At the end of 2023, the dry powder held by these assets stood at an all-time high of $3.9tn, according to *Global M&A Trends for Private Capital 2024 Outlook*. This is expected to be reversed somewhat as the interest rate cycle continues to head south.

But there are still concerns that fresh inflows risk diluting returns, all the more so as investors now demand greater scrutiny, transparency and liquidity in a challenging funding environment. More inflows may also risk greater regulatory scrutiny, although the US Securities and Exchange Commission has, for now, withdrawn its recent proposals on greater transparency in private equity.

Figure 1.2 **Which principal benefits are your pension plan expecting from its investments in private market assets?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"GPs in PE have to double down on value creation and not wait for markets to deliver multiple expansion, as in the past."

"With mega risks lurking in the background, we have to perform a delicate balancing act between high returns and capital conservation."

In this scenario, it is unlikely that private markets' distinctiveness from public markets will erode along key dimensions like transparency, liquidity, volatility, correlations and regulatory framework. In all these aspects, the majority of our respondents expect either no change or divergence over the next three years (Figure 1.3). But a minority also expect convergence, unless quality prevails.

The focus of new allocations will be on what they see as secular and more predictable sources of value creation emerging from the so-called 4D Revolution.

In any event, successful private market asset managers, known as general partners (GPs), will be those who have learned lessons from the abrupt end of the cheap money era and reorient their business models towards what their clients, limited partners (LPs), need in a less benign environment.

That seminal shift has reinforced the need to select GPs who have credible value creation plans, sound execution capabilities and reduced reliance on the state of capital markets to drive future returns. After all, private markets are all about active fund management at its best, relying solely on manager skills.

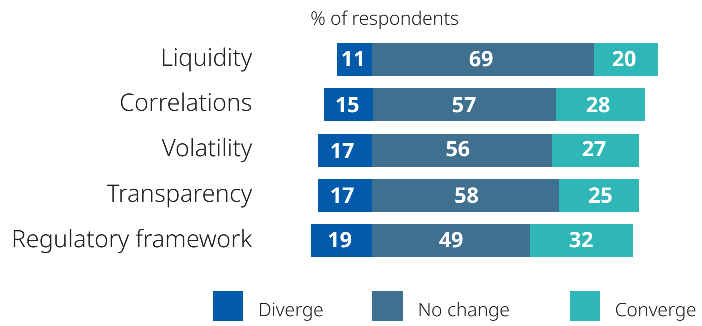
Thus, our respondents' process for selecting GPs is experiencing a makeover. Not only are they scrutinising past track records of GPs in thorough detail, they are also looking for indicators of investment capabilities that would ensure that a strong record has a high likelihood of replication in the future. They want proof points that their GPs can deliver their LPs' goals.

This particularly applies to the asset classes to which our respondents expect to increase their allocations over the next three years. In descending order of importance, they are: private debt, private equity, infrastructure, real estate and venture capital. Likewise, the preferred destinations of their investments are likely to be: North America, Europe, Asia-Pacific, Latin America, the Middle East and Africa.

In all cases, the focus of new allocations will be on what they see as secular and more predictable sources of value creation emerging from the so-called 4D Revolution – powered by decarbonisation, decoupling, demographics and digitalisation – now in progress in the global economy. With geopolitical uncertainty, our respondents think it prudent to deal with crises as and when they arise, whilst using secular trends as portfolio 'shock absorbers'.

Going forward, therefore, the survey respondents are cautiously optimistic that their GPs will likely meet their LPs' new needs in a radically changed environment.

Figure 1.3 **As more capital flows into private markets, what will happen to investment aspects between private and public markets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"After the 2022–23 debacle, our due diligence has become more robust: we want to be sure that GPs have what it takes to deliver."

"The future belongs to those GPs who can ride the 4D Revolution and extract value from it."

Part 2: Asian emerging market

1. Asian emerging markets are implementing reforms to attract foreign capital

Asian emerging market assets have remained under-owned, despite their 46% collective weight in global GDP. But now there are positive straws in the wind.

The survey respondents' current total allocations to all these markets are skewed to the low side (Figure 1.4): 38% have zero allocations and a further 51% have allocations of up to 10%. Only 11% have allocations in excess of 10%. The contributory factors fall into two sets: external and internal.

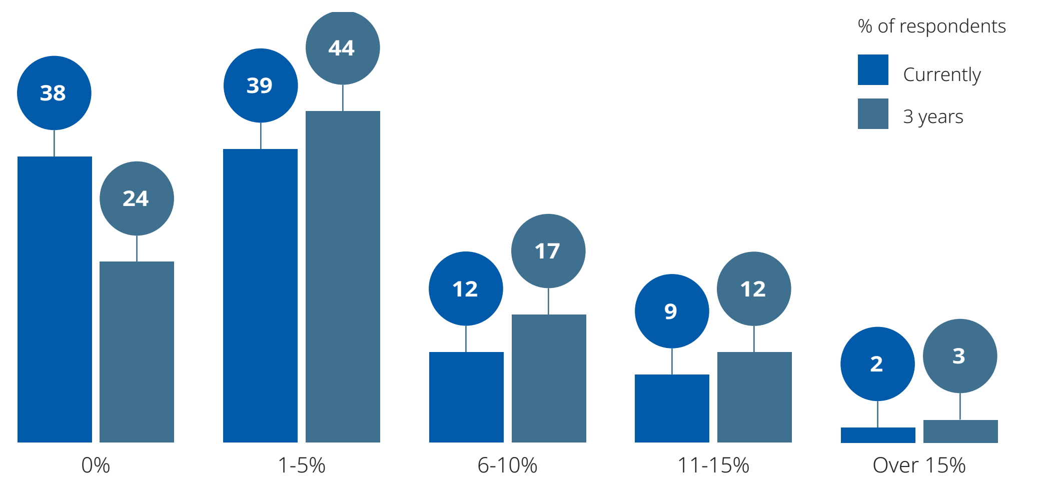
On the external side, both China and the US are vying for decoupling in trade and finance to promote their own strategic interests, thus intensifying geopolitical risks. This has drowned out the good economic fundamentals of the region, for now. Indeed, allocations were higher before the Russian invasion of Ukraine. But the resulting exclusion of Russian assets from key emerging market indices sparked unplanned exits from China due to worries that it may face similar delisting with rising China–US rivalry.

Yet another external factor has been the last US interest rate cycle. As in previous cycles, steep and prolonged hikes in 2022–23 hit Asian emerging market assets, as many of their companies had funded their growth with US dollar debt.

Internal constraints, on the other hand, centre on inherent structural features of these countries. Some features are market related: high volatility; limited free floats in stock markets due to the controlling interest of the state or founder families; and the slower evolution of legal systems to protect shareholder rights. Other features are politics based: opacity in national and corporate governance and undue government interference in the affairs of large companies in pursuit of its own ends. Together, these constraints have prevented many markets from converting their favourable growth dynamics into high earnings per share.

Thus, Asian emerging market assets have remained under-owned, despite their 46% collective weight in global GDP. But now there are positive straws in the wind. While growth outlook is expected to remain favourable, policymakers are taking steps to overcome constraints in order to attract foreign capital to decarbonise their high-emission sectors, as a part of the structural transition from a low-income to a mid-income to a high-income economy.

Figure 1.4 **What is the approximate share of all Asian emerging market assets in your pension plan's total investment portfolio currently, and what will it be in three years' time?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"The world is fragmenting into two distinct economic and currency blocs – the biggest change since the 1989 fall of the Berlin wall."

"The two main political parties in the US are racing to prove who can be toughest on China."

Some Asian economies, such as China, are moving towards the high value-added end of manufacturing. Some are seeking to capitalise on their large youth population (Indonesia and Philippines). Some are improving corporate governance and shareholder rights (India and South Korea). Even the China–US rivalry has a silver lining: reconfiguring global supply chains away from China towards its neighbours is likely to produce investment opportunities.

As a result, our respondents expect to raise their allocations modestly (Figure 1.4). Over the next three years, the proportion of respondents investing in all Asian emerging markets is likely to rise from 62% to 76%: with extra emphasis on the unique dynamics of each country. This selectivity has been due to big dispersion in their lifetime return outcomes so far, as shown in Section 4. On the upside, 32% of respondents had returns that exceeded or far exceeded their expectations; with 31% reporting that they were on par with expectations. On the downside, 37% had returns that fell below or well below expectations. Value premium has coexisted alongside value trap.

The 'emerging market' label conceals more than it reveals.

Greater selectivity by country has reportedly favoured two groups of winners among our respondents. The first group had targeted underpriced assets with high intrinsic value, based in countries with political stability, the rule of law and better investor rights (e.g. India and Singapore). The second group had targeted countries with which they have strong physical presence and cultural familiarity (e.g. China and Vietnam), backed by the required governance expertise and skills sets to work with local partners.

Thus, the 'emerging market' label conceals more than it reveals. It covers economies with strong diversity in political systems, economic maturity, business cultures and risk exposures. Not all emerging markets are created equal. Lumping them in a bundled strategy is no longer attractive.

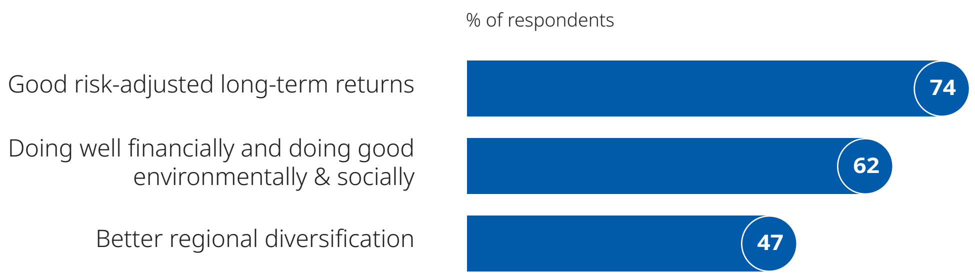
2. Pension investors are targeting good risk-adjusted returns as well as sustainability impacts

The case for raising allocations rests on the belief that the region has the potential to deliver the three benefits that are being targeted (Figure 1.5): good risk-adjusted long-term returns (74%), triple bottom line benefits (62%) and better regional diversification (47%). In their pursuit, respondents expect to follow one or more of three strands.

The first strand is structural: favouring countries under the so-called *China Plus One* strategy of global companies, relocating part or all of their production out of China to other Asian countries with more promising fundamentals. India and Vietnam rank highly among favoured locations.

The second strand will likely target companies across Asia that are still trading at deep discounts to their net asset value. For example, in the past, the P/E ratio of the

Figure 1.5 **Which principal benefit is your pension plan expecting from its investments in Asian emerging markets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Bundling Asian emerging markets in an index means that they all tend to suffer when there is bad news in one of them."

"Asia has made good progress on new stock market rules on ESG disclosures, enhancing the scope for 'green' alpha."

US-based chipmaker Nvidia peaked at 243, while its much larger Taiwanese counterpart TSMC managed a high of only 33, according to market data.

The third strand will likely involve a contrarian stance on countries believed to be close to a state of 'peak pessimism' that is grossly mispricing their assets. In particular, China faces the prospects of a prolonged balance sheet recession, as its beleaguered property sector repairs its broken finances while households cope with the negative wealth effect from falling house prices. On both these fronts, however, the latest proactive policy measures have improved market sentiment by signalling the government's resolve to fix the real estate market, boost the economy and revive consumer confidence.

Favourable growth trajectory and governance reforms apart, survey respondents also perceive the region as offering good opportunities to harvest 'green' alpha, as shown in Section 4. Countries as diverse as China, India and Indonesia are expected to become major players in the green economy.

Countries as diverse as China, India and Indonesia are expected to become major players in the green economy.

This much is reflected in the respondents' investment choices over the next three years. Thematic funds top the list of traditional asset classes, followed by green, social and sustainability-linked bonds.

On the equities side, Indian equities are ranked high and Chinese low, with others in between. In turn, this is mirrored in respondents' choice of favourite nations for future allocations: India, South Korea, Taiwan, China, Vietnam, Indonesia and Malaysia, in that order of preference.

As for alternative assets, the sentiment is likely to be more muted, on account of the steep discounts on net asset values inflicted by the last US interest rate cycle and continuing narrow exit options for maturing funds.

Overall, both active and passive funds are likely to prevail in new allocations. On the active side, three avenues are likely to be used. The main one is investing in Asian companies listed in Asian emerging markets. It is perceived as being conducive for harvesting alpha by focusing on their intrinsic potential to convert favourable growth outlook into high earnings per share.

Another avenue for targeting alpha will involve making allocations to developed market companies with high profit exposures to Asia. Such exposures are now reckoned so high that their country of formal domicile is less material. The avenue also offers greater liquidity and governance transparency. For the same reason, the third avenue will involve investing in Asian companies listed in developed markets.

On the passive side, broad-tent index funds and ETFs with an Asian focus will top the list. Some will seek to exclude China. The latter's volatility and subpar returns over the past decade have been a drag on the returns of these funds, given China's largest weight at the time.

Indeed, the single country focus is likely to gain traction. This trend is in contrast to the current shift towards global equities rather than country allocations. It is also in contrast to the past practice of investing in broad emerging market indices, where the gap between the best and the worst companies was pronounced, as was their turnover in regular index rebalancing.

Besides, survey respondents may become more cautious about passive funds covering China, due to new bipartisan measures now being considered by a committee of the US House of Representatives (see Section 5).They aim to exclude China from all key market indices. The stated reason is that such funds do not perform adequate due diligence on the unique risks inherent in Chinese companies and the threats they pose to retirement savings. For now, the shape of final legislation is unclear. That it will go through seems certain under the new US administration, as will its planned blanket tariff increase on all US imports from China. What is uncertain now is the speed and size of increase and how China will respond. It might mitigate the impact by, for example, redirecting its planned fiscal package. Our survey respondents are in wait-and-see mode.

Overall, geopolitical risks now feature high on our respondents' agenda. They will likely moderate their allocations to Asian emerging markets until the stance of the next US administration on China becomes clear. For now, liquidity has

Interview quotes

"Progress on converting high growth into high earnings per share will continue at variable pace between countries."

"Narrower country-based index funds will increasingly become popular at the expense of broader EM index funds."

Asian emerging markets will continue to merit a place in a diversified pension portfolio due to lower correlations with developed markets.

taken precedence over opportunity, and geopolitics over corporate fundamentals.

3. Convergence between Asian emerging markets and Western developed markets is likely

The actions being taken by these markets in attracting foreign capital are indicated by the likely scale and scope of their adoption of investment practices now prevailing in the West (Figure 1.6). More respondents perceive some convergence than divergence in key investment practices. At least two in every five respondents perceive convergence over the next three years in five areas: corporate governance and investor rights (58%), market volatility (56%), liquidity and depth of capital markets (52%), stewardship (49%), and regulatory framework (41%).

Fewer expect convergence on return expectations and correlation of asset classes in the belief that the favourable growth outlook of these markets will serve to retain their distinctiveness. In other words, Asian emerging markets will continue to merit a place in a diversified pension portfolio due to lower correlation with developed markets.

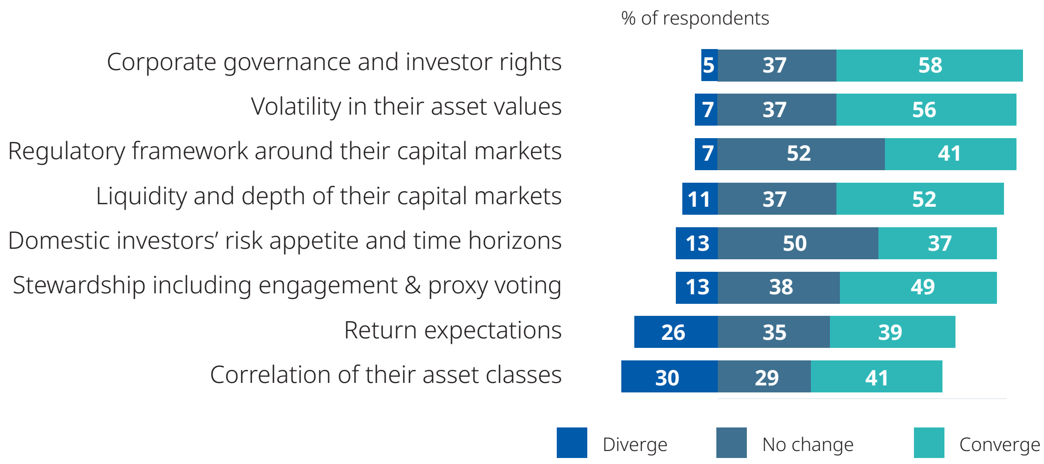
This is duly reflected in the two sets of criteria used to select external asset managers for Asia mandates. One is a past track record that demonstrates that they are capable of meeting clients' investment goals. The other is a suite of capabilities to ensure that past record has a high likelihood of replication in the future.

The goals in question centre on good risk-adjusted returns, credible ESG outcomes, lasting stewardship impacts and a widely admired thought leadership brand on Asia. In turn, capabilities will centre on a value-for-money fee structure, a deep talent pool, strong physical presence on the ground in Asia and membership of international advocacy networks such as Climate Action 100+ and UN PRI.

Overall, the foregoing criteria underscore two imperatives in manager selection: to secure a financial as well as an ESG alignment of interests; and to ensure that the next wave of Asian growth has a distinct qualitative dimension. The battle against climate change will be won or lost in Asia.

Continuing improvements in institutional frameworks and fiscal sustainability will underpin the ongoing convergence process. For survey respondents, the known downside risks now inherent in Asian markets are only exceeded by future upside potential.

Figure 1.6 **How are Asian emerging markets likely to evolve as investment destinations compared with developed markets in the West over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Asian emerging markets are moving closer to developed markets in terms of corporate governance and regulatory framework."

"Asian economies now have independent central banks, current account surpluses, less dollar-denominated debt and higher FX reserves."

2 Private markets:
What has the experience been so far?

Overview

This section does a stocktake on three issues applying to survey respondents' investments in private markets:

- where are they now in the traditional adoption cycle and what have been the outcomes so far?
- how have private market assets featured in the investment approach?
- what factors have constrained allocations in the recent past?

Key findings

a. Adoption cycle and outcomes

In the adoption cycle:

- 74% of survey respondents have already made allocations of varying sizes to private markets;
- 49% have allocations under 15% and 25% have allocations above 15% of their portfolio;
- regionally, the biggest allocations emanate from the US, followed by Europe and Asia-Pacific;
- the US is also the favourite destination of private assets, followed by Europe.

As for outcomes:

- at the top end, 28% report that lifetime returns thus far have exceeded or far exceeded expectations;
- in between, 40% report that returns thus far have been on par with expectations;
- at the lower end, 32% report returns below or well below expectations.

"Private markets need new growth drivers, now that the era of very low interest rates is over."

An interview quote

b. Investment approach

The private market has relied on two approaches:

- 51% include private assets in their strategic asset allocation;
- 20% deploy such assets in a dedicated stand-alone sleeve;
- assets are mostly invested in individual stand-alone funds and, to a lesser extent, multi-asset funds.

c. Factors constraining allocations

These fall into two sets:

- factors that are external to private assets, including hard-to-model rising geopolitical risks and concerns about higher-for-longer interest rates;
- factors that are inherent in private assets, including high fees and charges, illiquidity, and opacity in the investment process.

Key message

Well before the bear market of 2022, allocations to private markets were based on the premise that liquidity would not be an issue in a continuing era of cheap money. The new consensus is that interest rates will be higher than in the period after the 2008 global financial crisis, but will gradually normalise.

Accordingly, the current approach will remain a pragmatic blending of opportunity and caution. Whilst the fear of missing juicy returns remains a powerful driver, capital conservation is a key imperative. Both require a delicate balancing act in pension portfolios.

Private market assets have met return expectations so far

Survey respondents have been investing in illiquid private markets since the 'Yale Model' pioneered by the late David Swenson gained prominence in the 2000s. They are now at varying stages in the adoption cycle (Figure 2.1, left chart): 21% are at the awareness-raising stage, 5% are close to decision making, 22% are in the process of implementation and 52% already have a mature portfolio of different private market assets.

As we saw in the Executive Summary (Figure 1.1), these allocations vary in size, with 49% having allocations below 15% and 25% have above 15%. Regionally, the biggest allocators are domiciled in North America and Europe. As for the destination of their investments, the US is the epicentre, followed by Europe and Asia-Pacific.

A key driver is differences in regulation and investment cultures. For example, the primacy of the US as the destination of private assets is attributable to less-restrictive commercial laws that facilitate corporate takeover bids, which has powered the rise of private equity's buy-out deals. As for the biggest allocators, the accounting rules used by US public sector pension plans permit the use of the expected rate of returns on their investments as a discount rate in measuring future liabilities. With high expected returns on private assets from the illiquidity premium, the resulting higher discount rate has reduced liabilities and improved the funding ratios of these plans.

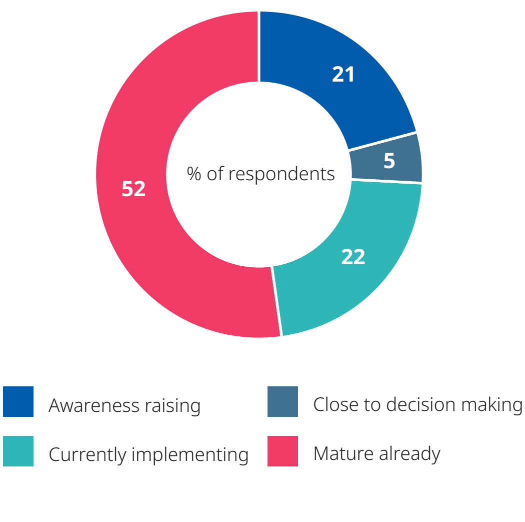
As for lifetime portfolio returns (net of fees) on private assets, these have varied between asset classes.

As for lifetime portfolio returns (net of fees) on private assets, these have varied between asset classes. In rank order, typically, the averages for venture capital have been in the high upper teens, those in private equity and private debt have been in the low teens, and those in infrastructure and real estate have been in high single figures. Overall, these have been favourable but with wide dispersion (Figure 2.1, right chart).

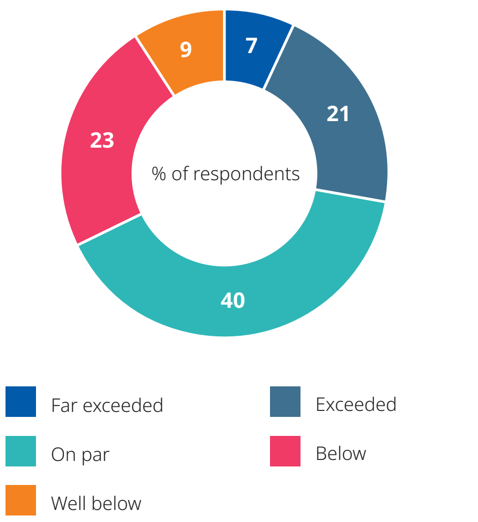
On the upside, 7% report that overall returns have far exceeded expectations, and a further 21% say that they have exceeded expectations. On the downside, 23% say that they have been below expectations and a further 9% say that they have been well below expectations. The remaining 40% say they have been on

Figure 2.1

In which stage of the adoption cycle is your pension plan currently with respect to private markets?



Have your private market investments met your pension plan's overall investment expectations so far?



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Private market assets have longer time horizons. They require different governance and skills capabilities compared with public markets."

"We have been investing in private markets since the 1990s. Our returns have varied over time but the net gains have been attractive."

With wide return dispersion, illiquidity premium has been far from guaranteed.

par with expectations: with a 'hurdle' rate of 8%, roughly 2% higher (net of fees) than their public market assets.

This variability reflects the differing inherent attributes of individual asset classes in the current $13tn private market universe, as estimated by the consultancy Bain & Co.

In our survey, eye-popping returns have been more evident among private equity and venture capital. Early vintages were more successful, as competition for quality assets was modest then, creating prime mover advantage. This accrued to those survey respondents – mostly larger plans – with longer time horizons, and the requisite governance and skill sets to invest in illiquid high-risk/high-return assets with long lock-up periods. Those respondents with big enough asset heft and a prominent brand also benefited when their GPs granted them the right to co-invest directly into deals without having to build in-house origination capabilities, while also avoiding or minimising management charges and performance fees. In the process, the LPs also had direct access to quality companies in their stewardship role.

At the other end, recent vintages in private equity have suffered a triple whammy: inflated prices paid for quality assets in the banner year of 2021, the drying up of exit channels since the 2022 bear market and declines in deal making.

This has left general partners with a towering $3.2tn in unsold assets – covering 28,000 unsold companies – according to Bain & Co. Some survey respondents had to resort to secondary markets to sell their assets at sizable discounts on their net asset value to meet their immediate cash flow needs. With wide return dispersion, illiquidity premium has been far from guaranteed, especially in Asia-Pacific (see INSIGHTS).

The other asset classes – infrastructure, private debt and real estate – have mostly delivered as expected, with the exception of commercial office-based real estate. It has been hit by the growing trend towards home-working since Covid, marking a structural shift in that asset segment. Overall, return expectations for these other asset classes are modest in comparison to private equity, private debt and venture capital. But, on the upside, they also offer contractual or 'pass-through' links to inflation, as does private debt via floating interest rate structure that protects against inflation.

Interview quotes

"The ability to secure co-investment or club deals is a major driver of high returns in private equity."

"The lower expected returns on some private asset classes are compensated for by the contractual inflation protection they offer."

INSIGHTS

With an uncertain outlook for rates, return expectations are being lowered

The dot.com crash in 2000 was a watershed, after the traditional equity–bond diversification failed just when it was most needed. It intensified our search for lowly correlated assets. Having seen how well the big US endowments had weathered that storm, we initiated a phased advance into private markets, starting with real estate, then private equity, then venture capital and then infrastructure.

By the middle of the last decade, we went into private debt, as Basel III, introduced after the 2008 Global Financial Crisis, constrained the lending policies of commercial banks.

Our current total allocations to these assets amount to 29%, with 16% in private equity, 6% in real estate, 3% in infrastructure, 2% in private debt and 2% in venture capital. The average annual return for the total portfolio has hovered around 10%.

But this rosy scenario is unlikely to persist as the Fed funds rate rocketed from zero bound to 5.25% during 2022–23. Since then, the new rate reduction cycle is unlikely to go far because of three structural changes: rising public debt, the reconfiguration of global supply chains and the huge sums needed to finance climate action. With a more uncertain outlook for interest rates, we have had to lower our return expectations.

Now, more than ever, fundamentals matter. Our GPs have to focus on extracting intrinsic value that can override market conditions.

A US pension plan

Private market assets are part of strategic asset allocation

As we saw in the previous subsection, 74% of survey respondents are already invested in private assets with varying allocations. That they perceive themselves to be long-term buy and hold investors is further indicated by the fact that 51% of them treat private market investments as part of their SAA, and a further 20% treat them as part of a dedicated stand-alone sleeve in their portfolios (Figure 2.2, left chart).

As a top-down approach, SAA is used by respondents who have been gradually increasing both the breadth of private market assets in their portfolios and their depth via rising allocations.

The process looks at a raft of asset classes that can be used to meet plans' pension obligations as they mature. Long data series are used in complex models to assess past performance and predict future performance in light of likely evolution in macro risk factors such as GDP growth, inflation, interest rate and climate change.

Based on historic relationships between asset classes and such risk factors, asset choices are made, duly considering their underlying return drivers as well as their liquidity and volatility features. They are also segmented, with each portion having its own policy on the weight of portfolio allocations and their benchmark for returns. For our respondents, this approach has three clear merits.

First, with its own policy goals, private market investing is no longer constrained by the traditional cap-weighted benchmarking framework. Implicit in the goals is the belief that risk factors embedded in private market assets can be duly compensated over time by higher returns, lower volatility and a more efficient diversification. Indeed, this belief now underpins favourable narratives on private market assets.

Second, being part of SAA means taking a longer-term view and eschewing the feast-and-famine mentality that promotes panic buying and selling in public markets driven by periodic dislocations. These pro-cyclical herd behaviours are less prevalent in private markets, owing to their illiquid nature. When they prevail, deep discounts in asset values have been inevitable.

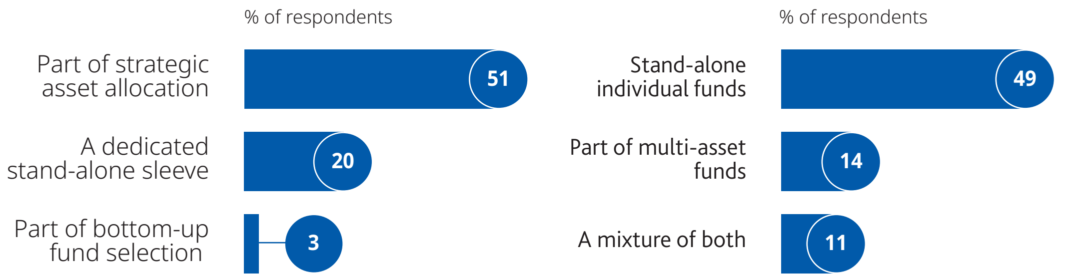
Third, this focus on the longer term within a policy framework makes private market assets particularly suitable for ESG investing, especially for searching out climate opportunities. Many private market companies are at the cutting edge of green technology such as carbon capture and hydrogen fuel. These have long gestation periods that public markets struggle to price. Indeed, many of our respondents'

This focus on the longer term within a policy framework makes private market assets particularly suitable for ESG investing, especially for searching out climate opportunities.

Figure 2.2

How do private market assets appear in your overall investment portfolio currently?

How would you describe your pension plan's current approach to private market assets?



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"As part of strategic asset allocation, private assets are free from the tyranny of cap-weighted benchmarks."

"With higher interest rates and wider spreads, first-lien private debt has delivered yields as high as 14% – well above high yield bonds."

In most cases, allocations have targeted the less risky senior part of the capital structure of the funds concerned.

allocations to impact investing – targeting financial, social and environmental benefits – have been channelled into private markets, especially private equity and private debt; where stewardship activities are more effective in view of the ownership structure and customised covenants (see INSIGHTS).

As for the approaches used in private markets, the main one relies on stand-alone individual funds (49%), as shown in Figure 2.2, right chart. In private equity and private debt, this reflects the emphasis on funds of different vintages. In infrastructure and real estate, in turn, it reflects the focus on specific projects and asset types.

In all cases, it reflects the focus on single strategy specialists operating either as independent boutiques or part of multi-strategy platforms. In most cases, allocations have targeted the less risky senior part of the capital structure of the funds concerned.

In contrast, survey respondents with smaller allocations to private markets have preferred open-ended multi-asset funds that aim to capture illiquidity premium (14%).

Such funds help to manage liquidity constraints by including liquid public market assets in portfolios as a rebalancing device that protects the existing locked positions on private assets. Such funds have gained popularity in the past five years, as market ructions have hit pension plans with the 'denominator effect' in their SAA. As public market assets have lost value, illiquid private market assets have become artificially overweight. This has forced a scaling down in new commitments or has paused them altogether to get back in line with SAA targets. In mitigation, this scenario has led 11% of respondents to use both stand-alone and open-ended funds.

Overall, current concerns about private market assets owe less to their inherent features and more to external factors, such as higher-for-longer rates and hard-to-model geopolitical risks that could potentially spark a liquidity crunch, as seen in 2022–24.

Interview quotes

"Multi-asset funds partially help to overcome liquidity constraints on private market assets."

"Given their ownership structures and legal covenants, private market assets are more amenable to ESG investing than listed assets."

INSIGHTS

Private market assets central to ESG agenda

Alongside risk and return, ESG ranks as the third pillar of our asset allocation. We have set the net zero goal by 2050 for our portfolio across all three scopes of greenhouse gas emissions (GHG). We were one of the earliest to go into climate investing and have built out the necessary investment expertise and corporate culture to meet this ambitious goal by doubling our allocations to climate transition by 2030. Our approach is three pronged, all hardwired to use forward-looking data and credible proof points that ESG investing works in practice.

First, we hold stakes in listed equity in hard-to-abate sectors such as steel and aluminium. Our stakes are big enough in some cases to get us a seat on the board and exercise our stewardship role in transitioning climate laggards into leaders and thus generate 'green' alpha.

Second, we have sizeable stakes in pure play listed impact companies where returns and impacts are interdependent. We also partner with governments and multilateral bodies, sponsoring blended finance projects that tackle global warming. With sponsors taking the front-end risk, overall risk-adjusted returns are attractive, backed by much-needed diversification of our asset base.

Third, we have large holdings in private markets, especially private equity and infrastructure targeted at large green projects. In both cases, as GPs are the ultimate owners of businesses in their portfolios, it has been easier to have explicit ESG targets in the mandates.

Our ESG process starts with pre-deal evaluations and screening. Then comes ESG due diligence of the prospective GPs' philosophy, governance and track record. Finally, we have side letters to formalise contractual metrics agreed during due diligence. Active engagement and monitoring then follows.

In the past, we have turned down investment opportunities over ESG concerns, since we aim to use our influence to promote the net zero goal across global capital markets.

A Canadian pension plan

Limitations of private market assets are well recognised

The implied pragmatism seeks to blend opportunity and caution

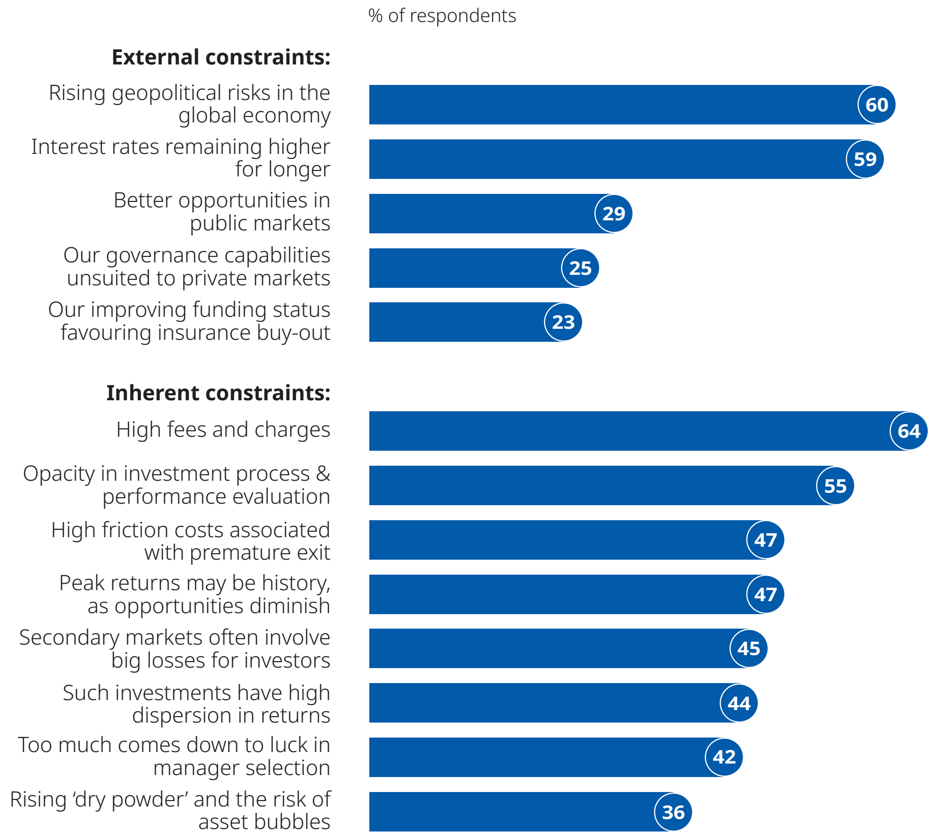
Private market assets have acquired TINA ('there is no alternative') status. Yet, as we saw in Section 1 (Figure 1.1), their allocations are likely to rise modestly in the near term. The implied pragmatism seeks to blend opportunity and caution. This is due to two sets of constraints.

The first set covers the external factors constraining allocations (Figure 2.3, upper panel). Rising geopolitical risks buffeting the global economy top the list (60%). Historically, such risks covered wars. Now, they also embrace cyber-attacks, deglobalisation and the economic rivalry between the US and China causing a growing chasm in the global economy. Investors have been driven from risk to uncertainty (see INSIGHTS on the next page). Our respondents are left to perform a balancing act between the fear of missing out and capital conservation.

Another major external constraint has been the prospect of current interest rates remaining higher for longer (59%). In private equity, they have hit the IPO pipeline in volatile markets, making it challenging to exit on fund maturity and return capital to clients. This has caused a precipitous drop in capital distributions in the buy-out and venture capital space.

Higher rates have also made it harder for private equity portfolio companies to service their often significant debt, while also suffering a fall in the discounted present value of future profits and thus lowering the

Figure 2.3 **Which factors have constrained your pension plan's investments in private market assets in the recent past?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Central banks are increasingly worried about a rising level of government debt that requires interest rates to remain higher for longer."

"So far, PE funds have relied more on multiple expansion and less on margin growth. The days of windfall returns from cheap money are over."

value of portfolio companies. In private debt, higher rates have jacked up default rates and forced the revision of deal terms. In real estate and infrastructure, higher rates have seen big falls in capital values.

On a lesser scale, three other external constraints have also been at work. Some respondents see better opportunities in public markets (29%). Some have governance structures and skill sets that are not suited to private market investing (25%). Some have healthy funding status, as higher interest rates have reduced the discounted value of their future pension liabilities and permitted an insurance buy-out (23%).

Turning to constraints that are inherent to private market assets, a few are noteworthy (Figure 2.3, lower panel). High fees and charges top the list (64%). This applies to the traditional 2-20 fee model in private equity, venture capital and, to a lesser extent, private debt. The model is justified on the grounds that such assets are typically less mature, harder to replicate and more reliant on active management than the public market equivalents.

Another high-ranking constraint that especially applies to these three asset classes has been opacity in their investment process, performance evaluation and identity of fellow investors (55%). As these illiquid assets are not actively traded, they have no easily observed market value. Their regular valuations are more a matter of personal judgement than hard science. Private credit typically involves unrated or unlisted companies and is thus much less transparent.

As these illiquid assets are not actively traded, they have no easily observed market value. Their regular valuations are more a matter of personal judgement than hard science.

Three other lesser constraints have also held back allocations. First, given their illiquid nature, there are high friction costs caused by premature exit (47%), and relying on secondary markets for liquidity can often involve sizeable discounts on net asset values (45%).

Second, there are concerns that such investments have high dispersion in returns whilst requiring largish ticket sizes (44%). Thus, too much comes down to manager selection (42%).

Third, peak returns may become history as the opportunity set has become diminished with a wall of new money (47%). This is shown by high 'dry powder' (36%), indicating a build-up of bubbles where too much money chases too few opportunities. Global private capital dry powder has achieved a compound annual growth rate of 11% over the past 10 years, ending 2023 with an all-time record $3.9tn; equal to just under a third of the private asset universe, according to *Global M&A Trends for Private Capital 2024 Outlook*.

Interview quotes

"Our sizeable pay-out requirement forced us to sell PE assets in secondary markets, as our GPs could not use the usual exit routes."

"Our risk assessment process requires far more transparency in private equity and private debt than is currently available."

INSIGHTS

Going from risk to uncertainty

Rising geopolitical tensions argue for having a more nimble portfolio with ample liquidity filters. Our experience shows that leverage fuels the financial system's profits, but it also creates damaging bubbles.

Good returns on private equity has overly relied on layers of debt at ultra-low bank rates to buy companies. Banks, in turn, have been lending not only to buy-out firms, but also to the funds that acquire them, the firms that manage them and the investors that back them. Also, most of our own PE returns have come from the expanding market multiples helped by cheap leverage, rather than an improved efficiency of portfolio companies. We are now only investing with GPs who are able to tilt the balance the other way.

On transparency, the US Securities and Exchange Commission's latest proposals on greater transparency especially around performance measurement and investment process were rejected by the Court of Appeals. They also required detailed quarterly fund and fee reporting, and annual audits.

Private debt is also causing concern after its over-rapid growth has been driven by regulatory arbitrage as commercial banks faced tougher rules on their lending. A recent IMF report warned that without more supervisory oversight, the prevailing vulnerabilities could pose systemic risk, especially with the growing interconnections between private debt, private equity and real estate in cross asset class funds.

Hence, our allocations to private markets now pay attention to a host of risk factors that were barely material when we made our investment ten years ago. We pay as much – if not more - attention to risks as to returns.

A Dutch pension plan

3 Private markets:
What is the future outlook?

Overview

Taking a three-year forward view, this section covers the following issues:

- what will be the key drivers of returns in private markets?
- which asset classes and regions are likely to be favoured in the process?
- how will different regions fare as destinations of investments?
- what are the GP selection criteria for the new generation of mandates?

Key findings

a. Return drivers

Two sets of drivers will be at work:

- the external ones are not directly related to private markets and include the heightened search for good returns in a low real return era and the prospect of further cuts in interest rates by key central banks;
- the internal ones are directly related to private markets and include more growth companies than ever likely to be in private markets and remain private for longer.

"We are hard-nosed investors looking for financial and societal outcomes."

An interview quote

b. Asset allocation

Private markets have entered an era of slower growth marked by three trends:

- return to fundamentals and lesser reliance on market growth;
- rising importance of secondary markets as a source of liquidity;
- primacy of thematic investing as a key source of value creation.

In descending order of importance, asset allocation by survey respondents is likely to favour the following asset classes:

- private debt
- private equity
- infrastructure
- real estate
- venture capital.

In descending order, the following regions will be most favoured:

- North America
- Europe
- Asia-Pacific
- Latin America
- Middle East & Africa.

c. Selection of GPs

When selecting GPs, two sets of criteria are seen as essential: their past track record and investment capabilities that ensures it has a high likelihood of being replicated in future. The key items under track record are:

- the delivery of clients' financial and ESG goals;
- fees and charges that reflect value for money;
- consultant rating, as due diligence turns more rigorous;
- longevity and stability of the deal-making team.

The key items under capabilities are:

- transparency around investment process and performance valuation;
- capabilities to manage loan work-outs in distressed situations;
- membership of influential corporate networks to facilitate deal flows;
- membership of global advocacy groups to hasten ESG progress.

Key message

The returns in private markets are likely to be less juicy than in the recent past but not enough to diminish their appeal. An increasingly larger share of global value creation is expected to occur in the private markets now seen as a gateway for growing companies. At the same time, the fundamentals of underlying asset classes have come under intense scrutiny, as the era of market-driven returns fuelled by central banks' cheap money policies has finally ended.

Search for better returns will drive fresh allocations

This relative optimism about private markets is supported by prospects for further cuts in interest rates.

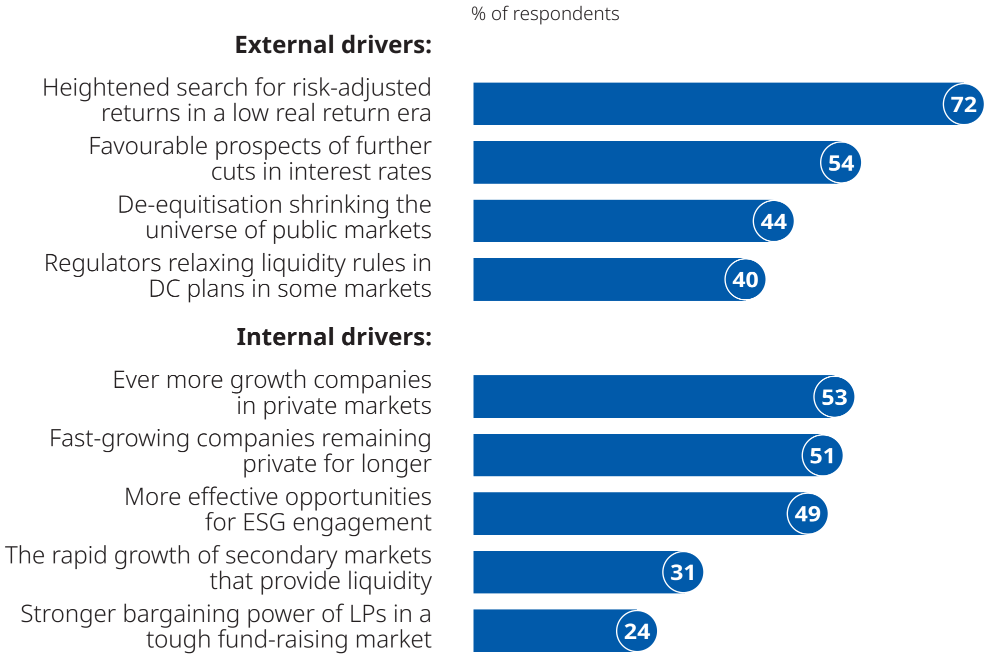
As we saw in Section 2, our respondents' continuing interest in private markets is moderated by a dose of realism about their limitations in today's environment. On balance, the rewards of going into private markets continue to exceed the results of staying out for the majority of our respondents. At this stage of the current cycle, two sets of drivers are fuelling this interest: one external, one internal (Figure 3.1).

Taking them in turn, 72% of respondents will continue to search for good risk-adjusted returns in private markets in the belief that public markets are now in or likely to be in an extended era of low real returns and high volatility (upper panel). This relative optimism about private markets is supported by prospects for further cuts in interest rates (54%). With inflation well down from the near 10% level reached after Covid on both sides of the Atlantic, central banks in China, Europe and the US have kick-started the rate-cutting cycle this year. The level at which rates will settle is unclear. The one that gives full employment and price stability – the neutral rate – might well have risen, due to dislocations across the globe caused by Covid, the Ukraine war and supply chain disruptions.

In the absence of further major macro shocks, survey respondents expect the benchmark Fed funds rate to fall to 3.75% over the next 2 years, from a 23-year high of 5.25–5.50%. The fall will be big enough to soften the current stress in private markets as well as forestall the threat of a recession. But two concerns will limit the size of the likely fall. One concern centres on the inflationary effects of the 4D Revolution.

Another concern is the mounting pile of sovereign debt in all countries, especially the US and China. For example, by 2035, US debt is set to rise by $7.5tn under the Trump presidency, according to the Committee for a Responsible Federal Budget, a non-partisan group. Overall, President Trump's proposals on blanket higher tariffs, tax cuts and immigration

Figure 3.1 **What will be the key drivers of your pension plan's interest in private market assets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Public stock markets are no longer representative of the global economy. Private markets are a gateway to growing companies."

"Central banks are cautious about cutting rates even though the signs of a soft landing are there. They worry about mounting public debt."

curbs are expected to raise inflation and limit the scope for rate cuts.

Another external factor driving interest in private markets is the structural de-equitisation of public markets in the West (44%). It has been caused by big share buy-backs and the dwindling pipeline of IPOs that is shrinking the public markets universe (see INSIGHTS).

The final notable external driver is the relaxation of liquidity rules in Defined Contribution (DC) plans in some pension markets (40%), following the example of Australia, Canada, the Netherlands, Singapore and Switzerland. The UK's latest initiative aims to offer limited liquidity in plans' default funds, while encouraging inflows into private equity and venture capital. It envisages a market place for intermittent trading in pre-IPO private assets. The EU's latest regulation – ELTIF – also allows private debt to be structured as open-ended funds with a minimum lock-up period.

So much for external drivers. Turning now to internal drivers, two related factors top the list: ever more growth companies in private markets (53%) and fast-growing companies preferring to remaining private for longer (51%). This is because the IPO process in key stock markets is seen as cumbersome and the bureaucracy of public markets as onerous. This is just when growth capital can be readily accessed in private markets over extended periods by high-quality companies growing at double-digit rates annually, while crucially enabling their owners to retain control. The latest available published data from Pitch Book illustrate the point with regard to the US, the poster child of private equity. Over the period 2000–21, the number of companies in its universe shot up from around 2,000 to 9,958, whereas the public market number shrank from around 7,000 to 4,805.

Yet another notable internal driver is more effective opportunities for ESG engagement (49%). As we saw in the Executive Summary (Figure 1.2), 56% of our respondents are targeting a triple bottom line in their private market allocations. Given the bilateral nature of legal covenants, it has been easier for LPs to engage with GPs in year-round dialogue on strategy and ESG issues more than is possible in public markets.

Given the bilateral nature of legal covenants, it has been easier for LPs to engage with GPs in year-round dialogue on strategy and ESG issues.

Finally, the last two internal drivers relate to the rapid growth in secondary markets providing liquidity to investors seeking an early exit (31%) and the stronger bargaining power of LPs in a tough fundraising market (24%). Both are seen as welcome developments.

Interview quotes

"By the time growth companies come to stock markets, the best of the upside is gone. It's better to get into them at the pre-IPO stage."

"From a modest start, secondary markets are developing rapidly and improving the ecosystem of private markets."

INSIGHTS

De-equitisation reflects a structural problem that favours private markets

The universe of companies in listed equity markets in the West has been contracting in this century due to a combination of factors. They include growing investor short termism, bureaucratic listing requirements and excessive regulatory scrutiny. These have been augmented lately by the share buy-back boom that enhances earnings per share, the contracting pipeline of IPOs that means fewer growth companies seeking a listing, and cheaper availability of capital elsewhere, as interest rates plunged in the last decade.

There are fewer public companies now than there were 40 years ago, and they are, on average, much larger and older.

Since 2010, these public markets have not grown much beyond a level that can be explained by movements in share prices that have benefited from the cheap money policies of central banks. By borrowing against future returns, they have increasingly disconnected from the real economy. They are more about the second order trading of existing assets that favour cash distribution and balance sheet management; and less about wealth creation that promotes jobs and societal prosperity.

Indeed, a 2017 Arizona State University study showed that the entire gain in the US stock market since 1926 can be attributed to the best performing 4% of listed stocks. Today, that market is top heavy, with a tiny proportion of companies – the 'Magnificent Seven' – accounting for around a third of the S&P 500 assets.

In contrast, the universe of companies in private equity and private debt is expanding rapidly. Their longer-term fund structures prevent investors from fire sales during times of stress, as so often happens in public markets.

A Finnish pension plan

Private markets have entered an era of slower growth

In light of the growth drivers cited earlier, private market assets will continue to attract moderate net inflows, even though returns are likely to be lower with bigger dispersion. Three points are worthy of note before looking at the fortunes of individual asset classes in this extended subsection.

a. Return to fundamentals

Performance is now everything, as is the intrinsic worth of the assets that underpin it.

Intrinsic value will be front and centre for new allocations. The overall inflow of new money will remain subdued after the banner year of 2021.

The drivers of high inflows finally reversed with spikes in interest rates and inflation, leading to the 2022 bear market. GPs have been forced to hold on to assets to avoid selling in a lower-multiple environment and LPs have reacted by reining in new allocations.

The sheer speed and size of interest rate shock during 2022–23 and its impact on asset values has driven a wedge between buyers and sellers.

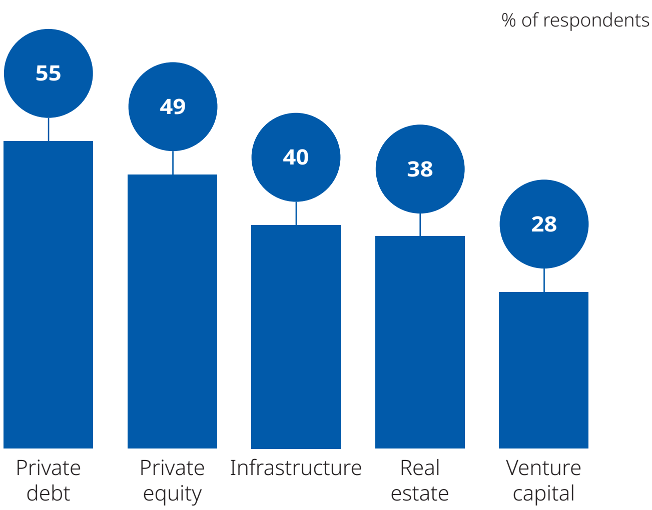
Taking a three-year forward view, the worst of that self-reinforcing cycle appears to be over. Inflation is expected to return to levels close to central banks' targets without a sharp fall in economic activity. Conditions are improving for further rate cuts. But the financial engineering that boosted returns in the past will not be enough.

This is because our respondents also want to see a parallel boost in the business excellence and operating leverage that deliver sustainable earnings growth and margin expansion in their portfolios of companies in private equity, private debt and venture capital.

Performance is now everything, as is the intrinsic worth of the assets that underpin it.

Illiquidity premium has to rely more on idiosyncratic fundamentals of the underlying assets than periodic tailwinds from monetary policy.

Figure 3.2 **To which private market asset classes is your pension plan expecting to increase its allocations over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Now that the era of cheap liquidity is over, it remains to be seen how many PE managers are able to deliver double-digit returns."

"Secondary markets may well emerge as a distinct asset class in their own right in private markets."

The new inflows are likely to target themes based on the transformational mega forces now in play.

b. Rise of secondary markets

Secondary markets in all private assets are likely to grow rapidly. With the growing emphasis on fundamentals, they are expected to be a more efficient venue for meeting the periodic cash flow needs of pension plans as well as extending the duration of top-performing funds.

After all, our respondents want to avoid a repeat of recent episodes wherein lower-than-normal cash distributions on maturing assets turned many of them into forced sellers and made them exit at big discounts to meet their immediate cash flow needs, creating opportunities for bargain hunters.

In today's turbulent geopolitical environment, there is a growing reluctance to have capital tied up for extended periods without credible exit options when red flags emerge.

There is another reason behind this apparent caution: record levels of dry powder in all private markets currently. It has emerged from fundraising at the tail-end of the pandemic combined with limited scope for deploying it. It is seen as a sign of a declining opportunity set that also requires more efficient secondary markets.

c. Primacy of thematic investing

The new inflows are likely to target themes based on the transformational mega forces now in play that aim to provide solutions to large and complex problems. They are seen as the key sources of more predictable value creation from the 4D Revolution (see INSIGHTS on page 27).

The Revolution is turning the spotlight on pure play companies whose business models are solely focused on the chosen themes.

Such companies prevail more in private markets and have the potential to leapfrog their public market peers by directly investing in chosen themes with a higher likelihood of more positive targeted impacts.

In the climate area, they include, for example, forestry, green buildings, hydrogen technology start-ups and solar projects. In the social sphere, they include educational and community facilities.

In contrast, public markets are more suited to investing in, for example, hard-to-abate transition assets, like gas and oil, that account for a significant share of global greenhouse gas emissions, as they become greener over time in line with the Paris Agreement targets. Additionally, the coal phase-out, especially in emerging markets, will require private–public partnerships that will offer opportunities to private equity houses. In all thematic areas, our respondents' approach requires deeper levels of disclosure to enable robust verification and reporting.

Against this background, our respondents' interest in individual asset classes is likely to vary (Figure 3.2). Comments on each asset class are given below.

i. Private debt

Private debt tops the list (55%), with direct lending, real asset financing and distressed debt garnering most attention. The sectors to be favoured are healthcare, real estate, renewables, carbon capture technologies and social infrastructure. In a market environment in which public equities and bonds are likely to remain highly volatile, returns in this asset class are deemed to be guaranteed at par on maturity in the absence of major write-downs.

Historically, it has delivered returns in the 12–15% range comparable to public equities but with less volatility. They are now expected to be in high single digits and mainly generated from fees and margins, with equity-like participation rare. Most loans will be secured, allowing lenders to step in easily and recover capital in work-out situations: the process of working out a new debt structure in the event of a default.

The all-weather attributes of private debt (e.g. first-lien status, legal protections, regular cash flow, customised solutions, sound collateral and inflation protection) will continue to be seen as a source of alpha returns, while serving to minimise defaults and maximise recoveries.

These attributes appear to outweigh the three key expected downsides: the likely reduction in yields, lower credit quality in

Interview quotes

"Our impact investing mostly relies on pure play companies that tend to be in private markets."

"In the US, the Inflation Reduction Act is built to withstand political attacks. Tax credits are now funding new factories in Republican states."

the continuing absence of public credit rating, and the high debt service burden on portfolio companies if the rates remain higher for longer.

ii. Private equity

The next more widely favoured asset class is private equity (49%), favouring growth equity and, to a lesser extent, leveraged buy-out. The key driver here is the prospect of good returns by chasing growth companies preferring to stay private for longer. However, return expectations remain modest, as the asset class's internal rate of return fell below 10% in March this year: well below the 25% that investors used to aim for, according to *PitchBook*.

Future good returns are expected to move from public markets, dominated by a handful of large tech stocks, to racier private equity, which also provides further portfolio diversification by advancing into infrastructure, private debt, real estate and venture capital, as these asset classes become more interdependent. For example, large GPs in private debt are also investing in private equity, infrastructure and real estate.

For our respondents, these attributes currently outweigh the prospect of a reduction in returns from low teens to high single digits, for two reasons: the low likelihood of the type of multiple expansion driven by rising markets in the past; and the record dry powder that could potentially reduce the lifetime returns of recent vintages.

iii. Infrastructure

The third highest ranking asset class is infrastructure (40%). Once the backwater of private markets, it is emerging at the forefront of the 4D Revolution, especially the multiperiod push towards decarbonisation covering renewable energy, battery storage, electrified transport, electricity grid, electric vehicle (EV) charging points and green hydrogen.

Infrastructure has received powerful tailwinds from policy measures like the Inflation Reduction Act in the US and the Green New Deal in Europe. The asset class offers stable and predictable cashflows and has inherent features that mimic bonds. They are also backed by multidecade inflation-protected contracts. They will hold special appeal for our respondents with fast maturing liabilities that are index linked.

Infrastructure has received powerful tailwinds from policy measures like the Inflation Reduction Act in the US and the Green New Deal in Europe.

The Organization for Economic Cooperation and Development (OECD) estimates that an annual global investment of US$6.9tn per year is needed for the low-carbon infrastructure required to meet net-zero pledges.

For this reason, after suffering a precipitous decline in the past two years, our survey respondents have retained interest in illiquid infrastructures' potential as an early-stage asset class that has better return prospects compared with publicly listed infrastructure.

iv. Real estate

The fourth highest ranking asset class is real estate (38%). In the current dislocated macroeconomic environment, the focus is inevitably on quality assets with strong collaterals and good ESG credentials, selling at appreciable discounts.

The shift to a hybrid model of work has significantly reduced vacancy rates in office buildings, just as e-commerce did to retail shops. But the reportedly narrower gap in price expectations between buyers and sellers is improving price discovery and creating attractive buying opportunities.

The sectors likely to be targeted include budget and luxury hotels; data centres; education, healthcare and leisure facilities; electrical vehicle battery factories; industrial and residential properties, multi-family housing; logistics and self-storage units.

Returns apart, inflation protection remains a key driver of interest in real estate, where performance has exceeded inflation in six of the last seven inflationary periods for our respondents.

v. Venture capital

The last ranking asset class is venture capital (28%). In the recent market turmoil, it took the biggest hit because of the sector's higher risk–reward ratio. It continues to be seen as the most risky in today's private market

Interview quotes

"The prospect of higher-for-longer interest rates have somewhat curtailed the runway for solid growth in private markets."

"Infrastructure is likely to benefit significantly via blended finance initiatives involving private–public partnerships."

The prospects of fresh allocations to venture capital funds now hinge on when the backlog of the IPOs of the current generation of unicorns eases and investors can see the light at the end of the tunnel.

environment, as displayed by depressed deal activity and a stagnant exit environment in 2023.

Both took a toll on valuations and performance, after remarkable growth in the number of unicorns: privately backed companies with billion-dollar valuations. Their market value soared from $235bn in 2014 to $4.5tn, according to Morningstar Unicorn Market Monitor; with AI, high density sodium-ion batteries, cybersecurity and life sciences leading the pack.

VC themes that were once highly valued are witnessing a correction as market forces are pushing down valuations. But our survey respondents continue to wait for the next point of entry. The prospects of fresh allocations to venture capital funds now hinge on when the backlog of the IPOs of the current generation of unicorns eases and investors can see the light at the end of the tunnel.

In conclusion, there is now widespread recognition among our respondents that the macro conditions that fuelled the golden age of private market assets before 2022 is over, at least for the foreseeable future.

The next wave of growth will have to be powered by harnessing the intrinsic worth of these assets in a forward-looking approach that marks a break from the past.

Interview quotes

"We are targeting niche sectors like desalination, green hydrogen, natural capital and senior living."

"For the foreseeable future, we see venture capital as remaining a very risky corner of private markets."

INSIGHTS

Private market assets are seen as ideal for pure play exposures to mega trends

The investment landscape is in the midst of a tectonic shift following the 4D Revolution. Requiring huge scaled-up capital, each is seen as a more predictable point for value creation.

Since the COP26 in 2021, 145 nations have adopted, or are considering, net zero targets for close to 90% of global carbon emissions.

With rising geopolitical risk, decoupling is another key feature of the global economy since the pandemic. Trade protectionism is on the rise. The established web of supply chains that flourished previously are being decoupled and reshaped around two rival economic superpowers: China and the US.

As if that were not enough, in most developed economies, the demographic change is marked by ageing populations, declining fertility rates and a shrinking workforce. Hence, economic growth has slowed notably. New technologies and life sciences are seen as the key to sustaining and raising living standards.

No wonder digitalisation, including cyber security, is progressing apace, giving rise to business models that rely largely on intangible assets, allowing them to scale rapidly without much physical capital.

This transformative 4D Revolution is longer term in nature, driven as it is by innovation and physical investment, with long gestation periods and a strong focus on value creation among the pure play companies focused on the chosen themes.

With a preponderance of such companies, private markets provide opportunity to invest in the next newly minted publicly listed tech giant that is now still in the nascent stage of growth. That is where the best upsides are.

Public markets, in contrast, are too short termist, with an over-emphasis on quarterly numbers.

An Italian pension plan

North America will retain pole position

Rising geopolitical tensions are likely to re-channel cross-border flows of new money into OECD countries with a more developed market structure and stronger political alliances.

Prior to the pandemic, interest rates and inflation were low, liquidity was ample and the global economy was more integrated. None of these prompted strategic changes in the asset allocation of our survey respondents. Since then, new risks have emerged.

This has involved developing expertise in areas that now appear niche but are likely to offer scalable investment opportunities over the longer term. Typically, these cover a mix of defensive areas as varied as AI, green hydrogen, natural capital, senior living and the reshoring of global supply chains. There is also greater selectivity by geography, in contrast to the last market cycle.

Now, rising geopolitical tensions are likely to re-channel cross-border flows of new money into OECD countries with a more developed market structure and stronger political alliances in the West.

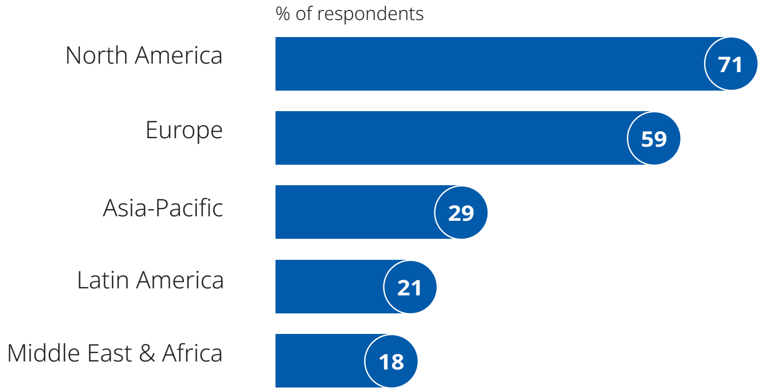
Against this background, North America will retain its gravitational pull (71%; Figure 3.3). In particular, the US is seen as providing fertile ground for all private assets, on account of its large domestic pools of capital and talent, a mature market structure around private assets, a strong regulatory framework, leadership in breakthrough innovations in sectors that go well beyond AI and, above all, safe haven status in periods of geopolitical turmoil.

Policy support in the US via the Inflation Reduction Act 2022 and the CHIPS and Science Act 2022 are seen as pivotal in decarbonising the economy and ensuring self-sufficiency in tomorrow's technologies. Canada, too, is catching up with its southern neighbour with its own green tax credits, making it the second most attractive market for renewable projects behind the US.

The next most popular destination for new investment is likely to be Europe (59%). Although its growth prospects look less impressive compared with the US, it has attracted the large US-domiciled private market conglomerates who are investing in a variety of assets – from long-established airports and mature real estate at one end to VC-funded startups across wide swaths of decarbonisation projects, involving 'solar parks' to storage batteries to carbon capture technologies. These are receiving strong tailwinds from the launch of the Green Deal Industrial Plan 2022 to boost Europe's net zero industry.

That apart, on the private equity side, many industries in Europe are still seen as being in the early phase of consolidation. This provides new value creation levers for their shareholders and buy-out firms – even in a lower economic growth environment. Europe is also likely to benefit from cross-

Figure 3.3 **Which regions will offer the best returns in private market assets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"The ability to exit successfully has become a key distinguishing feature of successful private market funds."

"The skills required to successfully navigate the current turbulence differ from those that delivered success in the last cycle."

Many industries in Europe are still seen as being in the early phase of consolidation. This provides new value creation levers for their shareholders and buy-out firms.

border investments – especially in real estate, where price corrections are opening up buying opportunities. However, it will continue to lag behind North America in the VC segment.

The third destination favoured by our respondents is Asia-Pacific (29%). Asia is already the second biggest private market region in the world at $2.5tn, surpassing $2.3tn in Europe, according to the *McKinsey Global Private Markets Review*.

There has been a sharp slowdown in fund raising in 2023 in response to geopolitical tensions between China and the US. In particular, the outbound investment rules banning IPOs in the US have been a drag. Similarly, inbound investment has been hit by restrictions imposed by the US in 2023. Other countries in Asia continue to be favoured by our respondents in the greening of real estate and energy infrastructure, as shown in Section 5.

As India exemplifies, with fewer legacy assets, Asia takes a clean-slate faster approach in these areas, instead of adapting assets which already exist, as is the case with North America. The exception is Japan, which continues to offer a deep pool of target companies with performance improvement potential, regulatory stability and low interest rates. However, the necessary market structure around private debt and private equity is only emerging gradually, even in an advanced economy like Australia (see INSIGHTS).

Our respondents' interest in the remaining two regions – Latin America (21%) and Middle East & Africa (18%) – is likely to be limited. Their private market structure is seen as being in the early stages of development. Another reason is that investment opportunities in these regions tend to rely heavily on domestic blended finance projects, which require partnerships with government and/or multilateral bodies. These typically attract only larger pension plans with the necessary governance structures and skill sets.

Interview quotes

"In real estate, the risk premium in Asia is much higher. The required internal rate of return is 17%, compared with 9% in the UK."

"The performance of private market assets in LATAM has been volatile. On fund maturity, the exit options tend to be very limited."

INSIGHTS

Leveraging domestic markets expertise to invest abroad

Around 25% of our portfolio is invested in local private markets, mainly infrastructure and real estate. Both have delivered good risk-adjusted returns and sustainability impacts. We have also partnered with some Canadian pension plans in 'club deals' in obtaining preferential terms from our GPs. As we have gained expertise and confidence in private assets, we have made modest advances into the private debt of mid-sized Australian companies engaged across the value chain of energy transition. Our allocations are very low, as the market structure is still in its infancy. On the upside, that has delivered a scarcity premium over private markets in Europe and North America. Our loans are secured by assets such as invoices, property and equipment. Their average duration is typically 1–5 years, with the scales decidedly tipped in favour of lenders. Demand continues to exceed supply, as commercial banks have withdrawn from risky lending.

Equity-like participation is rare. Defaults are low, and returns continue to be good and uncorrelated to public markets.

Since the end of Covid, we have also made allocations to private equity funds in India (healthcare) and China (digital economy). While the successful exit from older funds has become tough, we were able to pick up quality assets in secondary markets at big discounts to net asset value. For a long-term investor like us, it is hard to ignore the awakening of these two Asian giants.

An Australian superannuation fund

Prudent execution will differentiate winners from losers

The aim is to future-proof pension portfolios by capitalising on what are likely to be the focal points of value creation for the foreseeable future.

One by-product of the 2022–23 market turbulence was that the selection criteria for GPs came under the spotlight. Not only are our respondents scrutinising GPs' past track record in thorough detail, they are also looking for indicators of investment capabilities that can ensure the record's replicability in future.

As Figure 3.4 (upper panel) shows, far and away the most important criterion now being used is a good track record of delivering clients' financial and ESG goals (78%). In asset classes where corporate default is a key risk, low loss rates are vital. Either way, with the rising emphasis on thematic investing, the attribution analysis of the return drivers is enjoined to assess the role of the 4D Revolution in general and decarbonisation in particular. The aim is to future-proof pension portfolios by capitalising on what are likely to be the focal points of value creation for the foreseeable future. The other side of the coin is the stewardship role that GPs are required to exercise, given their direct customised access to companies in their portfolios. The role envisages a detailed plan of engagement with them around business strategy and ESG goals by setting out actions, KPIs and outcome timelines. Engagement now has to focus on narrative disclosure based on real life stories of actions and outcomes that lie behind the dry numbers of engagement.

The performance also needs to be backed by an incentive structure in which fees and charges reflect value for money (66%). GPs are enjoined to have a strong financial stake in outcomes, including progress on the ESG front. That means linking the compensation of senior executives and staff to well-defined ESG metrics and ensuring joined-up thinking between investment teams and stewardship teams.

Figure 3.4 **When selecting GPs for investing in private market assets, which criteria does your pension plan use?**

Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"We want to see a minimum number of names on the 'watchlist', compared with the current situation."

"It all comes down to credit underwriting standards and the quality of the business you lend to."

Such multiplicity of goals has added an extra layer of complexity in investment mandates. As a result, there is clear reliance on consultant ratings of GPs, based on in-depth proprietary research (51%). Independent third-party advice in investment due diligence has become essential.

The final area where good track record is essential is the longevity and stability of the deal-making team (48%). The goal is for 'cradle to grave' deal teams that can structure and negotiate the transaction so that the originators and underwriters remain on side for its entire duration.

Investors also need deeper insights into those idiosyncratic factors that underpin the illiquidity premia.

Track record, in turn, needs to be backed by investment capabilities that can inspire confidence about future replication. A key requisite is more transparency around the investment process, performance valuation and the identity of fellow investors (58%) This applies mainly to private equity. It is not enough that low volatility of assets rests on not being marked-to-market, making it easier to ride out ugly patches in markets, investors also need deeper insights into those idiosyncratic factors that underpin the illiquidity premia.

They also need to be assured that their GPs have the capability to manage loan work-outs in distressed situations caused by a borrower defaulting and forcing the loan terms to be renegotiated (45%). There is no substitute for having deep experience as lenders to troubled companies and also as their financial advisors in any subsequent restructuring. Both roles require being as close to the assets as possible.

Yet another valued capability is the membership of influential corporate networks to facilitate new deal flows (38%). The bilateral nature of mandates means that a lot of business referrals come through personal contacts and informal networks in public and private sectors. To facilitate that, membership of global advocacy groups – such as Climate Action 100+ and the UN Principles for Responsible Investment – are seen as helpful in burnishing ESG credentials (31%). This applies to GPs as much as to the portfolio of companies in which they invest.

Overall, our respondents want to see greater transparency into new underlying risks in their private market assets, so as to meaningfully assess their risk–return trade-offs (see INSIGHTS).

Interview quotes

"Our GPs need to have skin in the game so that they can share pain and gain equitably with their LPs."

"Successful strategy execution needs sound investment expertise, personal and corporate networks and operational excellence."

INSIGHTS

Selection criteria for GPs undergoing a makeover

Although private markets are now caught in the perfect storm of macro forces, the growth dynamics of the global economy remain in their favour. Recent events have shown how private markets thrived on cheap leverage that lifted the valuations of all asset classes. But we believe that the rise of private markets will continue as they attract the bulk of growth companies in all regions – with one difference. We want to know the lessons that have been learned from – and the actions taken – with the abrupt end of the cheap money era. For us, it has reinforced the need to select GPs with credible value creation plans, sound execution capabilities, and least reliance on capital markets to drive future growth. After all, private markets involve active management at its best, relying solely on manager skills.

We are looking for GPs with a proven track record in delivering their clients' financial and ESG goals, backed by a broad range of capabilities, valuation disciplines and sustainable sources of high-quality assets. The latter include growing companies with good cash flow, pricing power, financial discipline and management teams. Such attributes matter in assuring us that a good track record has a high likelihood of being sustained into the foreseeable future.

This emphasis on prudent execution also includes financial and non-financial alignment of interests. We expect our GPs – particularly in private equity, venture capital and infrastructure – to have a financial stake in investment outcomes, typically via equity investment. Equally, on the non-financial side, we expect our GPs to be good at spotting value opportunities and value traps to deliver our ESG goals.

An Irish pension plan

4 Asian emerging markets:
What has the experience been so far?

Overview

Aims

This section does a stocktake on Asian emerging markets via three issues:

- what is the current state of allocations to them and what have been the return outcomes so far?
- which factors have thus far served to constrain survey respondents' allocations to these markets?
- what factors are likely to drive interest in them over the next three years?

Key findings

a. Allocations and outcomes

The current status is:

- nearly 40% of respondents are not currently invested in these markets;
- the rest are either making their allocations now or already have a mature portfolio;
- returns have exceeded or far exceeded expectations for 32% of respondents;
- they have been on par with expectations for 31%;
- for 37%, they have been below or well below expectations;
- value opportunities have prevailed alongside value traps.

b. Constraints on allocations

Two sets of factors have constrained allocations in the past: external and internal:

- the key external ones include geopolitical issues, rising trade frictions and the last interest rate cycle in the US affecting asset values;
- key internal ones include high market volatility, opaque governance and the weak link between economic growth and asset prices.

"China is suffering from transition pains as it shifts from big wasteful construction projects to high-end manufacturing."

An interview quote

c. Future drivers

Two sets of factors are likely to drive interest in Asian emerging market assets:

- external ones include a heightened search for returns, falling sensitivity to the US rate cycle, the desire to improve ESG practices and the reconfiguration of global supply chains;
- internal ones include favourable growth dynamics, a shift towards high value-added manufacturing, favourable demographics and economic rebalancing towards high tech industries.

Key message

The geopolitical rivalry between China and the US is set to fragment the global order into two rival trading and currency blocks. This has cast a shadow over other countries in Asia.

On the whole, Asian emerging market stocks have remained under-owned, despite their combined weight of 46% in global GDP.

Countries are taking actions to enhance their appeal to foreign capital that is sorely needed to decarbonise their economies, among other objectives.

Additionally, the China–US rivalry also has a silver lining: it is likely to produce investment opportunities owing to the reconfiguration of global supply chains away from China. The race is on to be on the winning side.

Not all Asian emerging markets are created equal

Geopolitics have drowned out favourable economic fundamentals.

This report covers eight key Asian countries now in the MSCI Emerging Market index: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan and Thailand. To which we have also added Singapore and Vietnam, given their strong economic presence in the region. Of course, Singapore and South Korea are now developed economies. But for ease of presentation, they are included. As for allocations to this bigger group, our respondents are at different stages in the adoption cycle (Figure 4.1, left chart). At one end, 12% are at the awareness-raising stage and 26% are close to decision making. At the other end, 23% are now implementing their allocations and 39% have a mature portfolio.

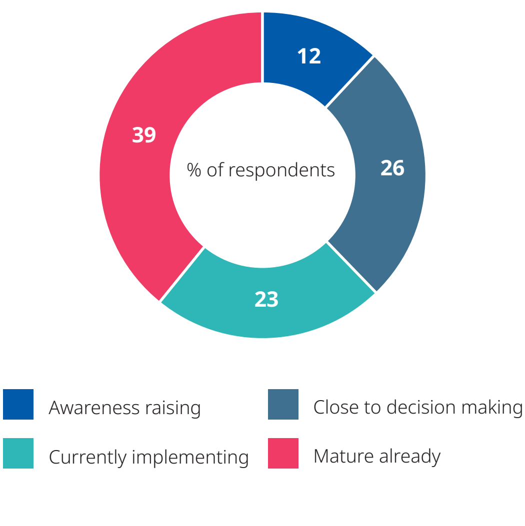
As such, the majority are already invested in our list of countries. Reportedly, this figure was higher prior to the Russian invasion of Ukraine. But exits in some cases were sparked by the delisting of Russian assets from key global emerging market indices, with their value plunging to zero. This has left a new risk hanging over a significant aspect of Asian emerging market assets. Investors tend to turn sour on emerging markets if bad news hangs over one of them. With rising political tensions between China and the US, there are concerns that Chinese assets may fall prey to this delisting. This is the aim of bipartisan legislative moves now underway in the US (see Section 5).

The problem has been worsened by political interference in the corporate sphere in China. It has drastically downgraded the market values of some of the biggest companies in the world, like Alibaba and Tencent. As we shall see in the next subsection, there have been other forces at work to dampen respondents' sentiments towards Asian emerging markets in the recent past. For them, one thing is clear: geopolitics have drowned out favourable economic fundamentals.

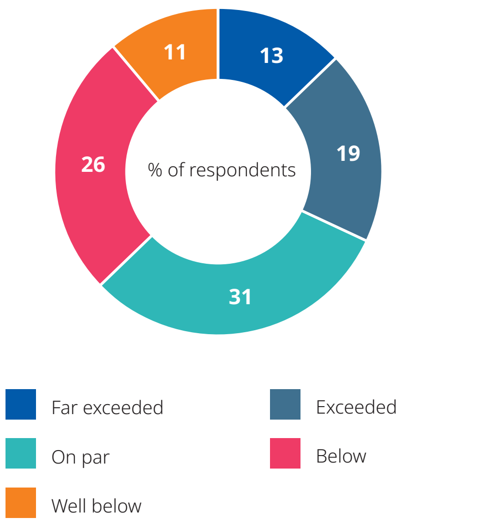
As shown in Figure 1.4 in the Executive Summary, the majority of respondents have allocations of no more than 5% of their portfolios. For them, the region's favourable growth dynamics have yet to translate into big investment gains across

Figure 4.1

In which stage of the adoption cycle is your pension plan currently with respect to investing in emerging markets based in Asia?



If you are already invested in Asian emerging markets, have your investments met your pension plan's overall investment expectations so far?



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Geopolitical risks require us to focus on single country idiosyncrasies rather than lumping them together."

"The removal of Russian stocks from the MSCI EM Index after its invasion of Ukraine shows how quickly key ESG issues can suddenly take over."

Impressive returns are reportedly based on a high degree of selectivity.

the board. However, the picture remains nuanced. Value premium has coexisted alongside value trap.

On the upside, as Figure 4.1 (right chart) shows, 13% have lifetime returns that far exceeded their expectations and a further 19% had returns that exceeded expectations; with 31% reporting that returns were on par with expectations. On the downside, 26% had returns that fell below expectations and 11% had returns well below expectations.

Impressive returns are reportedly based on a high degree of selectivity. Some respondents have focused on assets with high intrinsic value, based in countries with political stability and rule of law with stronger shareholder rights. In this context, Indian and Singaporean equities stood out. Some invested in countries in which they had established physical presence and sound cultural familiarity, duly backed by governance expertise and skills sets to work with local partners. Private equity in China and real estate in Malaysia stood out. Clearly, the 'emerging market' label conceals more than it reveals. It covers nations with strong diversity in political systems, economic maturity, business cultures and risk exposures (see INSIGHTS).

On the downside, those respondents whose investments did not do well fell into two groups as well. The first group were seeking prime mover advantage. They believed that favourable economic growth and the demographic outlook of some of these countries would, over time, deliver regulations, market structure and investor rights that were conducive to high returns for portfolio investors. As such, portfolio investment was predicted to follow the path of direct foreign investment in production facilities that turned China, India, Indonesia and Vietnam into favourite destinations of global companies seeking low-cost locations. Alas, in hindsight, the targeted advantage was slow to materialise.

The second group of respondents lost out by relying overly on passive funds. The high volatility and subpar returns of Chinese equities in recent years have been faithfully mirrored in the indices on account of China having the largest weight in them. This has overwhelmed the positive performance of other countries in the indices.

Interview quotes

"Lumping together a heterogenous group of countries in a bundled investment strategy is no longer viable."

"In EM indices, the difference between the best and the rest is huge. It reflects differences in corporate and country fundamentals."

INSIGHTS

After the 'lost decade', selectivity is the name of the game

As an investment strategy, BRICS caught our attention in the first decade of this century. Bundling together five of the then largest and fastest-growing economies – Brazil, Russia, India, China and South Africa – promised out-sized returns. Indeed, they materialised, just as US markets went into a decade-long ice age after the dot.com rout in 2000.

Suddenly, emerging markets were hailed as the investment of the millennium, until the 2008 financial crisis. It exposed their debt-driven growth models, just as US technology stocks started their prolonged and steep ascent. Apart from pockets of periodic cyclical uplifts, emerging markets have suffered a 'lost decade'.

The Morningstar US Equity Market Index has essentially tripled in value over the past 10 years. The Developed Markets Index (including the US, Europe and Japan) is up around 2.4 times. In contrast, The Morningstar Emerging Markets Index, covering 20 highly diverse developing economies worldwide, is only up 1.5 times.

Converting high economic growth into good returns required well-managed businesses focused on maximising shareholder value. Instead, what we witnessed were regular new issuances that reduced earnings per share, lapses in corporate governance and frequent political meddling. So, in this decade, we have had a fundamental rethink about our Asian emerging market investments.

Now, we use robust ESG filters when choosing companies in line with our investment beliefs. We also have a highly concentrated high-conviction portfolio that offers opportunities for direct engagement on corporate and ESG goals. We only invest in companies that are able and willing to engage with us.

A Swedish pension plan

Geopolitical issues have weighed on investor sentiment

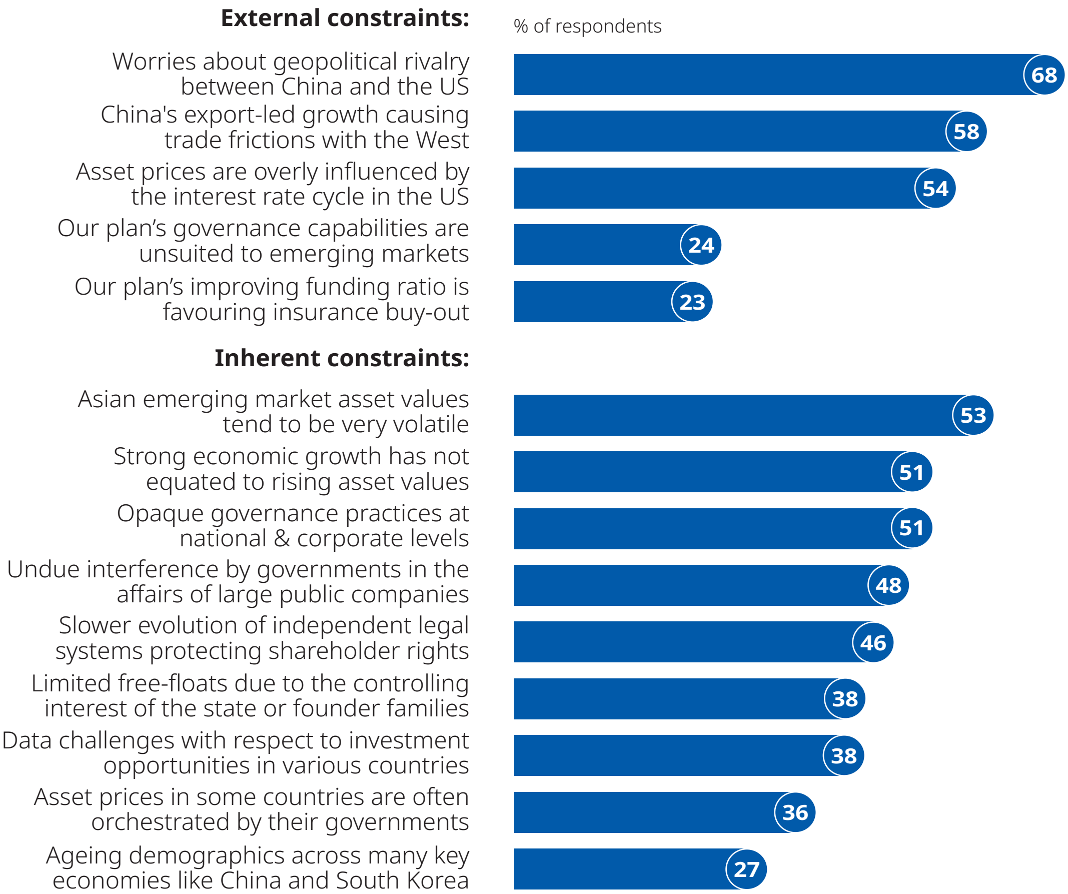
Rivalry has exacerbated trade frictions with the West due to China's 'dual circulation' strategy.

So far, two sets of factors have constrained survey respondents' allocations to Asian emerging markets: external and internal.

Taking them in turn, and as Figure 4.2 (upper panel) shows, rising geopolitical rivalry between China and the US has been a major constraint on allocations in the recent past (68%). The fallout has been felt across Asia, given the strong trade and investment links between China and its Asian neighbours via its $1tn 'One Belt One Road' initiative, also known as the New Silk Road.

Rivalry has exacerbated trade frictions with the West due to China's 'dual circulation' strategy (see INSIGHTS on the next page). Under it, China has made significant state-subsidised investments in high value-added manufacturing to compete directly with the US. This is resulting in over-supply and dumping the surplus onto export markets via predatory pricing. This is duly hurting the domestic industry in the West and ratcheting up trade frictions (58%). One example is China's export of EVs, in which it has become a world leader. It has invoked retaliatory tariffs from its top two export markets: the EU and the US. This is at a time when China's growth has slowed markedly and it is getting closer to Russia – economically and militarily – since the outset of the Ukraine war. In the US, both political parties were competing to prove who would be toughest on China. Indeed, things may get worse under the agenda of the next US administration: with blanket tariffs of up to 60 percent on goods from China and 20 percent on goods from everywhere else. Their timing and size are still very uncertain.

Figure 4.2 **Which factors have constrained your pension plan's investments in Asian emerging markets in the recent past?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"A fragmented global trading order, based on protectionism and 'friend shoring', is coming into view."

"In the past, US interest rate cycles had a major bearing on asset prices in Asia. That influence is weakening."

Governance practices at national and corporate levels have tended to be opaque.

Yet another external factor constraining allocations is the negative impact of the interest rate cycle in the US on broad Asian equity prices in home currency (54%). Historically, these have displayed an inverse relationship with the 10-year Treasury yield and the US dollar. Asian countries and their companies have typically funded their growth with US debt. As a result, the steep rises in the Fed funds rate in 2022–23 dampened allocations. This link, however, has been eroding lately (see next subsection).

The remaining two external constraints apply to our respondents themselves. Some have governance capabilities that are ill-suited to investing in emerging markets (24%). Some have healthy funding ratios that permit an insurance buy-out of their liabilities (23%).

Moving on to other constraints, these are internal to Asian markets (Figure 4.2, lower panel). They fall into two clusters.

The first one centres on asset values in Asia. These tend to be more volatile than their counterparts in the West (53%). For private sector pension plans in the survey, such volatility is unwelcome because it gets indirectly reflected in the financial statements of their sponsors and their share prices, under current mark-to-market accounting rules. That apart, as a whole, strong economic growth in Asia has not resulted in rising asset prices (51%). Intercountry differences are pronounced, as mentioned in the previous subsection. Besides, falling birth rates in key economies like China and South Korea are lowering the demographic dividend of the region (27%). Finally, there tend to be limited free floats in the stock markets due to the controlling interests of the state or founder families (38%). Allied to that, impartial legal systems that can protect minority shareholder rights have been slow to evolve (46%).

The second internal cluster centres on politics. Governance practices at national and corporate levels have tended to be opaque (51%). There is also undue government interference in the affairs of large companies (48%). Asset prices in some countries are often orchestrated by governments to act as circuit breakers and ignite 'animal spirits' during market stress (36%). China's earlier 'window guidance' – preventing designated investors from being net sellers of equities on certain days – is one example. This has been followed last September by backing Chinese banks to boost the equity markets by lending $114bn to investors. Such sugar highs are seen as tackling the symptoms, not the causes of the underlying malaise.

Finally, data for developing actionable insights into investment opportunities are not readily available (38%).

Interview quotes

"Nearly 60% of South Korea's GDP comes from 10 family-controlled firms known as chaebols."

"Political and corporate governance have been the Achilles heel of Asian emerging markets."

INSIGHTS

Both China and the US are vying for decoupling to promote their own strategic interests

China–US relations have gone from constructive engagement to strategic competition, so as to protect their economic and security interests.

One sticking point is the subsidies that China has lavished upon its manufacturing sectors to gain an unfair cost advantage. Hence, the US is reducing its reliance on Chinese imports via generous subsidies to its own producers and reshoring its supply chains towards its political friends and allies. It has also banned the export of key technologies to China. For its part, China has adopted a 'dual circulation' strategy. It aims to lower reliance on foreign technology by domestic import substitution, and pivot its trade with the fast-growing Association of the South East Asian Nations and other developing nations in alternative trading architecture insulated from US influence.

With US companies pulling some supply chains out of China, the latter may well lose its status as the world's go-to manufacturing hub. To counter that, it is advancing rapidly towards high value-added manufacturing by investing in tomorrow's technologies: like semiconductors for AI applications, EVs and life sciences. In response, the US has imposed stiff tariffs on Chinese solar panels and EVs, with more promised by the new US administration. Canada is already following suit. For now, the new mantra of self-sufficiency over economic efficiency will not only raise costs but also create new investment opportunities in strategic sectors like AI, defence, green energy and infrastructure in Asia. All these offer the prospect of a variety of differentiated outcomes at country, sector and asset class levels.

A German pension plan

Asian economies are tackling some deep-seated problems

The geopolitical upheaval will likely also have a silver lining due to its differential impact.

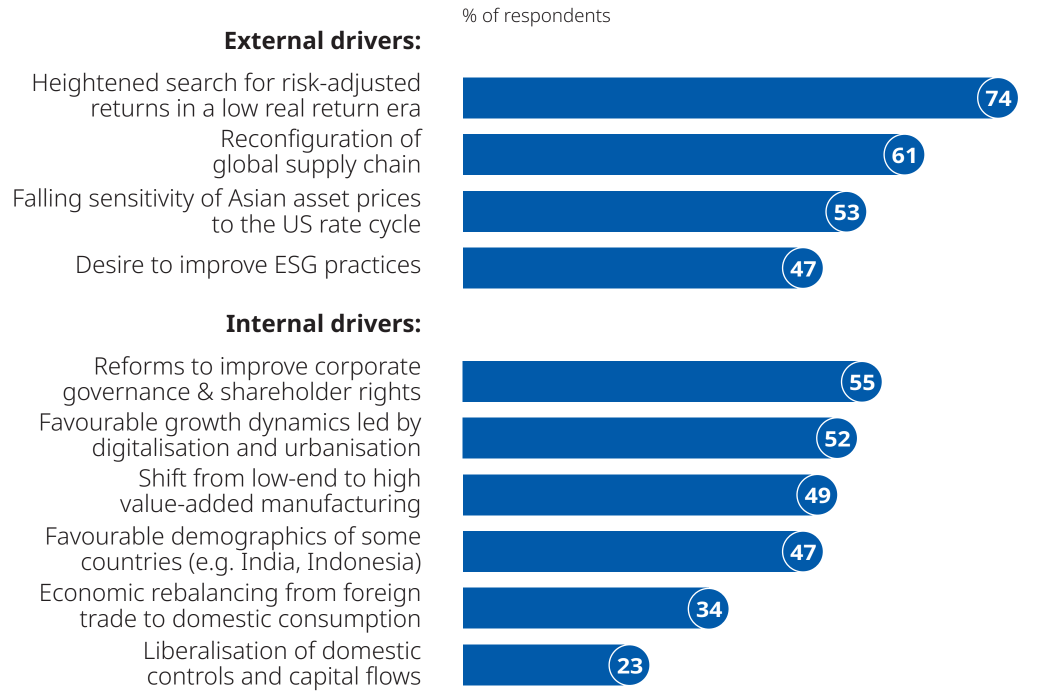
On a three-year forward view, our respondents expect to follow a three-strand approach that considers each country on its own investment merits. This is in the belief that the geopolitical upheaval will likely also have a silver lining due to its differential impact. The first strand is structural, where the *China Plus One* strategy will seek to avoid raising allocations only to China – as it has often done in the past – and diversify assets into other Asian markets with more promising fundamentals.

The second strand will likely target assets that are trading at deep discounts compared with their fair value. As an example, the P/E ratio of the US-based chipmaker Nvidia peaked at 243, while its much larger Taiwanese counterpart TSMC managed a high of 33, according to market data.

The third will likely involve taking a contrarian stance on countries that have not, as yet, reached a state of 'peak pessimism', leading to big price anomalies. This applies especially to China, now struggling to emerge from its Covid lockdown and facing a balance sheet recession, as its hugely leveraged property sector seeks to repair its broken finances and households experience the negative wealth effect from falling house prices. Some respondents believe it might turn out to be the sort of recession that dogged Japan for decades. The latest package of monetary measures announced last September will likely take longer to ease the entrenched deflationary mindset, if Japan's past experience is any guide.

In the meantime, any increase in the Asian allocations of survey respondents is likely to be very modest, as we saw in Figure 1.4 in the Executive Summary. Over the next three years, interest in Asian emerging markets will likely be driven by two sets of external and internal factors.

Figure 4.3 **What will be the key drivers of your pension plan's interest in Asian emerging market assets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"EMs have changed and matured significantly since the Mexican Peso Crisis and the Asian Financial Crisis of the 1990s."

"Some Asian GDPs and earnings are experiencing faster growth than those in developed markets."

There is a strong desire on the part of Asian markets to improve their ESG scores to attract long-term foreign capital.

Taking them in turn, the heightened search for good risk-adjusted returns in a low-return era tops the list (74%), as shown in Figure 4.3 (upper panel). In turn, the search rests on the view that capital markets in the West have long thrived on cheap money policies. With interest rates unlikely to revert to zero-bound any time soon, good returns are unlikely to prevail for long. In contrast, the 'friend shoring' of supply chains across Asia could potentially create a structural opportunity (61%). This is exemplified by tech giant Apple now moving some of its production to India.

Another favourable omen is the falling sensitivity of Asian asset prices to the US interest rate cycle (53%), as confirmed by the IMF's *2024 Global Financial Stability Report*. It shows that the average sensitivity of Asian emerging markets to the 10-year US Treasury yield declined by two-fifths during the current cycle compared with the 'taper tantrum' in 2013 when fears of imminent higher rates caused a market rout in Asia. This fall in sensitivity is expected to continue, as ever more Asian central banks gain independence and exercise strong monetary discipline.

To cap it all, there is a strong desire on the part of Asian markets to improve their ESG scores to attract long-term foreign capital (47%). This is sorely needed for them to meet their net zero goal.

Turning now to the internal factors driving interest in Asian markets (Figure 4.3, lower panel), fresh reforms to improving corporate governance and enhancing shareholder rights are gaining traction (55%; see INSIGHTS). Strong growth dynamics also ranks highly (52%). More markets are continuing their structural transition from low income to mid income to high income.

The last group already includes South Korea, Singapore and Taiwan. China and India are seeking to follow suit. China is doing so by moving towards the high value-added end of manufacturing (49%) and economic rebalancing from foreign trade to domestic consumption (34%). For their part, some countries – like India, Indonesia and Philippines – are seeking to capitalise on their large youth population (47%), and the liberalisation of domestic controls and capital flows (23%).

Interview quotes

"The rise of independent central banks and strong monetary discipline in Asia has reduced their dependency on the US rate cycle."

"The rising political rhetoric between China and the US should not blind investors to the investment opportunities that Asia still offers."

INSIGHTS

Regulators are pushing reforms to attract foreign investors

Two nations have been upping their game on corporate governance.

In the past, South Korea had corporate governance that put the interests of large conglomerates above those of ordinary shareholders.

Known as chaebols, these powerful family-controlled businesses had opaque shareholding structures, low transparency on decision making and low accountability around the perennial low return on capital. The country's tax rate of nearly 50% for high earners has deterred these families from raising dividend pay-outs.

The five largest of them comprise over half of the benchmark Korea Composite Stock Price Index; hence, the Corporate Value-up Program proposed this year by the Financial Services Commission is noteworthy. It aims to eliminate the long prevailing 'Korea discount' by reforming corporate governance standards to improve shareholder rights, accountability, transparency, capital allocation and price discovery.

In India, too, corporate governance is now an important theme, as it seeks to attract huge amounts of foreign capital for renewable energy projects. An upgraded regulatory regime seeks to improve the following: the protection of minority shareholders; accountability of the board of directors and corporate management; timely adequate disclosures to shareholders; and corporate social responsibility. As part of the upgrade, the Ministry of Corporate Affairs has mandated annual disclosures on some 500 ESG indicators and now tracks the progress of the top 1000 companies.

Hence, amid all the doom and gloom around geopolitics, the fundamentals are getting better in some Asian economies.

A Norwegian pension plan

5 Asian emerging markets: :
What is the future outlook?

Overview

On a three-year forward look, this section covers four issues:

- which asset classes are likely to receive fresh allocations?
- which countries will be the favourite destinations of the new allocations?
- which methods will be used to access the chosen asset classes?
- which criteria will feature highly in the asset manager selection process?

Key findings

a. Asset classes

- among traditional asset classes, the five most favoured are likely to be thematic funds; green, social and sustainability-linked funds; debt in hard currency; debt in local currency; and Indian equities;
- among alternative asset classes, the corresponding top choices are likely to be private debt, infrastructure, private equity and real estate.

"Thematic investing provides good 'shock absorbers' in the era of geopolitical risks."

An interview quote

b. Favourite destinations

In descending order of importance, the top five countries are:

- India, due to structural advantages (cited by 49%);
- South Korea, due to its head start in green technologies (43%);
- Taiwan, due to its expertise in the semiconductor value chain (36%);
- China, due to its value as well as contrarian opportunities (34%);
- Vietnam, due to its strategic partnerships with big powers (30%).

c. Favourite methods

The methods chosen to access these asset classes are likely to vary.

In active funds, the three key ones are:

- investing in Asian companies listed in Asian emerging markets (49%)
- investing in developed market companies with big profit exposure to Asia (43%);
- investing in Asian companies listed in developed markets (26%).

In passive funds, they are:

- index funds and ETFs focused on Asian emerging markets (41%);
- index funds and ETFs focused on a specific Asian country (30%);
- broad index funds and ETFs covering all emerging markets globally (21%).

d. Manager selection criteria

When selecting external asset managers for investments in Asia, the criteria used will take account of their track record and the investment capabilities that enhance the likelihood of its future replication.

Track record focuses on:

- clients' financial and ESG goals (63%);
- engagement and proxy voting activities (55%);
- investment themes linked to the Asian growth story (51%).

Investment capabilities focus on:

- a value-for-money fee structure with merit-based incentives (59%);
- a deep talent pool, providing innovative solutions (57%);
- strong physical presence on the ground in Asia (56%).

Key message

Thematic investing will define the next round of allocations to Asian emerging markets. While modest in size, the scope of allocations will extend from larger to smaller nations and via active and passive funds. Progress on converting Asia's favourable growth dynamics into high earnings per share will remain incremental.

Thematic funds are likely to lead the pack

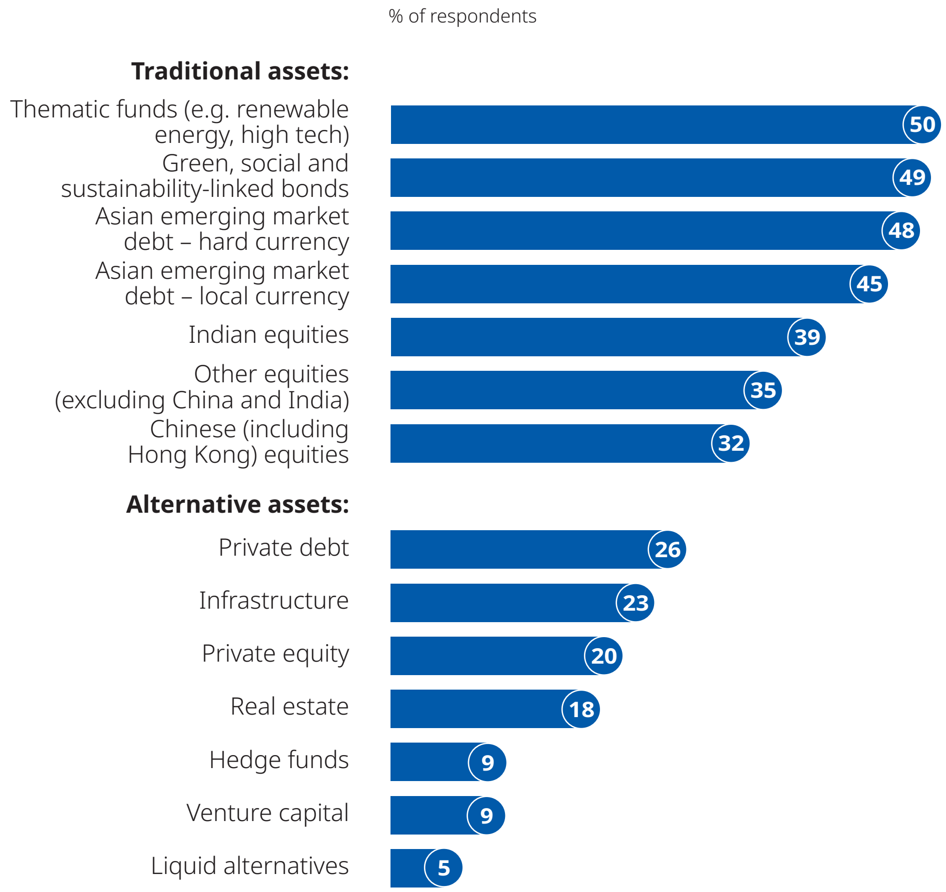
Following the publication of a taxonomy, Indonesia, Malaysia, Thailand and Vietnam are progressing in concert on the sustainability front.

Three features are likely to define respondents' new allocations to Asian emerging markets over the next three years. First, mega themes will play a significant role, so as to focus their assets on the most likely future secular sources of value creation. Second, bonds will likely prevail over equities, to minimise portfolio volatility. Third, public markets are likely to prevail over private markets, to access liquidity in times of stress. This subsection provides likely asset choices; the next one provides country background.

As Figure 5.1 (upper panel) shows, thematic equity and bond funds across the region are likely to top the list in traditional assets (50%). They are seen as structural opportunity, as defined in the last subsection. The themes in question include renewable energy, corporate governance, AI and the reconfiguration of supply chains, as Western companies seek to relocate from China into other Asian countries. On the ESG front, green, social and sustainability-linked bonds are likely to be favoured, as the region continues to seek foreign capital to create greener and more inclusive economies and societies (49%). Following the publication of a taxonomy, Indonesia, Malaysia, Thailand and Vietnam are progressing in concert on the sustainability front.

Next on the list are bonds, now perceived as value opportunity. Hard currency bonds are expected to become more attractive (48%), now that the rate reduction cycle

Figure 5.1 **To which Asian emerging market asset classes is your pension plan expecting to increase its allocations over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Thematic investing brings an extra layer of protection by providing a sharper focus on the key growth points in Asia."

"Asian bonds look attractive, now that the rate cutting has started in the US and Europe."

For now, liquidity has taken precedence over opportunity and geopolitics over fundamentals.

in the US has started in earnest. Local currency bonds too are likely be favoured (45%), as across Asia, independent central banks have been exercising strong anti-inflation policies and public finances are in much better shape. In China, policymakers are now unwinding the serious credit crunch in the beleaguered property sector and contemplating fresh fiscal measures to reboot the economy.

Listed equities are next on the list. Indian equities top the list (39%). India is seen as a structural opportunity based on its new status as *China Plus One*, as well as a number of reforms (see INSIGHTS). India is one of the very few emerging markets that has managed to convert high economic growth into strong earnings per share.

Other equities (excluding India and China) are likely to attract interest (35%). Nations such as the Philippines, South Korea, Taiwan, Thailand and Vietnam, are perceived as offering both structural and value opportunity.

In contrast, Chinese equities will most likely be seen as a mixed bag (32%). Some see them as a tactical play, as near-term price anomalies create attractive bargains. Yet, others believe the current gloom is overdone and see China as a contrarian play with strong repricing potential arising from the ambitious economic transformation now underway (see next subsection). China's importance to the global economy is hard to ignore.

Turning to alternative assets, interest is likely to be more muted (Figure 5.1, lower panel) on account of the steep discounts on net asset values inflicted by the last US interest rate cycle and the resulting narrow exit options. In all cases, the price discovery process has been slow, on account of the scale of recent losses. Private debt is expected to lead the pack (26%), as private equity managers are pivoting this asset class towards favourable structural themes, identified earlier. Infrastructure is next on the list (23%) where viable opportunities are emerging in Malaysia, South Korea and Vietnam. In contrast, private equity is unlikely to regain the pole position it held until the banner year of 2021 (20%). Much the same observation applies to real estate (18%). The remaining asset classes are unlikely to attract much interest from more than 10% of our respondents.

Overall, geopolitical risks feature high on our respondents' agendas and serve to moderate their interest in Asian emerging markets until the actual policy actions of the new US administration become clearer. For now, liquidity has taken precedence over opportunity and geopolitics over fundamentals.

Interview quotes

"Asian emerging markets offer one of the best value opportunities of all equity markets in the world."

"China needs a big fiscal stimulus and a reform package to revive business and consumer confidence to reverse its deflationary spiral."

INSIGHTS

Attractive outlook for India

Lately, India has edged ahead of China to become the top-weighted nation in the MSCI EM Investable Market Index for the first time. It has also joined the JPMorgan's GBI-EM Global Diversified Index, a widely followed EM local benchmark. It is due to join Bloomberg's EM Local Index in 2025.

Its equity markets are becoming large, deep and liquid, with a high level of daily turnover and lower correlations to both developed markets and other emerging markets. A robust IPO pipeline is bringing growth companies into the markets. Just as important, India's corporate governance is improving, as ever more listed companies boost their financial disclosure, board accountability and treatment of minority shareholders. This area has received attention from policymakers as investment culture has been taking root in the local retail population. Inflation has become lower and less volatile under the central bank's inflation targeting rules.

Just as important, the country has been a major recipient of foreign direct investment, as multinational companies have been diverting supply chains from China. Huge investments are being made in physical infrastructure as well as in the digital network.

The IMF anticipates the country to continue growing at around 6% and overtake China as the main engine of global growth by 2030. By then, it is expected to become the third largest economy in the world, surpassing Japan and Germany.

An UK pension plan

Smaller nations are appearing on the radar

Smaller Asian nations are now likely to attract increased attention due to the current economic travails of China.

In the past, the bulk of our respondents' investments by value went to four large markets: China, India, South Korea and Taiwan. They have had relatively better-defined market structure and an improving regulatory regime. Smaller Asian nations are now likely to attract increased attention due to the current economic travails of China (Figure 5.2). The following are the salient points that have emerged from our interviews.

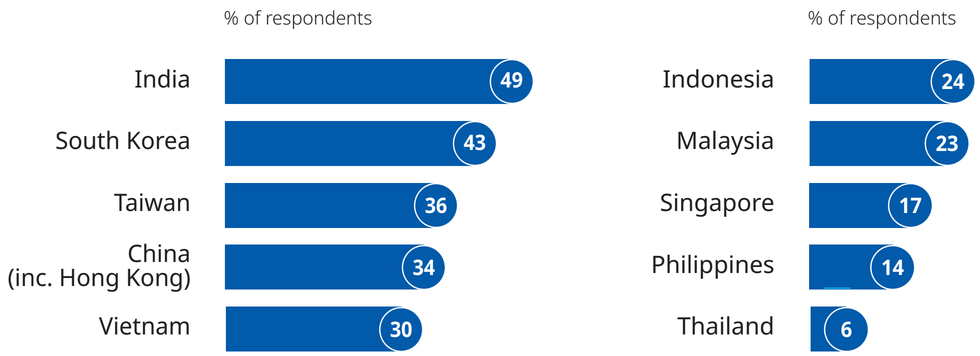
A key point is that, in new allocations, India will displace China, which has long held pole position (49%). The fifth largest economy in the world is now seen as shareholder friendly, with a favourable outlook for sustained economic growth and corporate earnings. It also has huge potential to harvest the 'demographic dividend' from its large youth population, relying on an education system geared towards science, technology, engineering and maths: all conducive to innovation across many sectors. India is also striving to reduce youth unemployment and attract women into the labour force.

Next on the list is South Korea (43%). It had a head start in solar energy, battery storage and cutting-edge memory chips. That advantage is being reinforced by the tech rivalry between China and the US. But worries persist about South Korea's fast ageing population undermining growth. And also about its chaebols – traditional growth drivers – losing their dynamism as they focus on commercialising existing technologies rather than developing newer ones.

Interest in Taiwan (36%) continues to centre on its world-renowned expertise in the vertically integrated semiconductor fabrication supply chain, including foundry, integrated circuit design services, server hardware and network switching. But the main concern is the rising tension across the Taiwan Strait potentially leading to military face-off between China and the US.

China ranks lower than its larger peers (34%), putting our respondents in two opposing camps. Optimists welcome the new decisive shift from the old economy of highly polluting industries to the new 'high quality development' model. This pivot towards a high-tech economy is meant to push China into high-income status. They also welcome the large package of ambitious monetary measures announced last September to ease transitional pain. Pessimists, in contrast, think that heavy-handed political interference in the private sector since 2020 has severely eroded corporate dynamism and risk-taking, despite impressive progress made on the ESG front (see INSIGHTS on the next page).

Figure 5.2 **To which principal countries in the Asian emerging markets is your pension plan expecting to increase its allocations over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"India is predicted to be the break-out nation, with a high growth rate and a credible reform agenda."

"Our interest in Asia is more broadly based than before. We are looking at smaller markets with pockets of good opportunities."

Singapore is noted for its carbon tax covering 80% of its emissions.

Vietnam ranks fifth (30%). Its technology sector has been expanding rapidly with a big pool of low-cost highly skilled coders, making it an attractive location for IT outsourcing for global companies. Regulations are now in progress to attract foreign investment – direct as well as portfolio. Its strategic partnership with China, Russia and the US is unique among Asian countries.

Indonesia (24%) aspires to become a major player in the green economy. With its large reserves of nickel, a metal used in batteries, it is ideally placed for nickel mining, smelting and battery production for EVs. It is also attracting foreign investments in its infrastructure of ports, power generation and distribution, fibre optics and data centres.

Malaysia (23%), under the China Plus One strategy, is expanding its capabilities at the back end of semiconductor manufacturing and attracting global companies. At the same time, Chinese companies are also using Malaysia as a base for exporting to Western markets to bypass new trade restrictions. Foreign direct investment has boomed. But now there are concerns that the US may blacklist the products manufactured by Chinese-owned companies operating in Malaysia.

Singapore (17%) is noted for its carbon tax covering 80% of its emissions. Under its net zero plan, the country is orienting its green finance policies towards new technologies like carbon capture, hydrogen and energy efficiency. It has also imposed climate disclosure obligations on its listed companies, using the Task Force on Climate-related Financial Disclosures framework.

Interest in the Philippines (14%) is centred on sizeable infrastructure investment in roads, underground metro and regional airports. With favourable demographics, the country is expected to continue its economic growth, as urbanisation progresses and tourism continues apace. The World Bank predicts that Philippines will soon become an upper middle-income country.

Interview quotes

"Vietnam's strategic partnerships with major powers is a big plus in attracting inward investment."

"Economic development in smaller nations will remain rapid because they suffer from few legacy issues."

INSIGHTS

China is bringing its ESG regulations in line with Europe

As the world's biggest carbon emitter, China is keen to attract foreign capital to accelerate its transition towards its dual goal: peak carbon emissions by 2030 and net zero by 2060. Hence, new rules are coming into effect from 2026. They require the nation's 400 biggest companies – listed and unlisted – to provide sustainability progress reports in line with the standardised guidelines produced by China's three main bourses. These companies are required to report their plans for decarbonising their businesses, progress made each year and the metrics used. The requirements broadly follow the template created by the EU under its Corporate Sustainability Reporting Directive. Thus, by focusing on the 'double materiality' principle, reporting requirements go well beyond the new guidelines from the International Sustainability Standards Board. They enjoin the affected companies to look beyond the impact of ESG risks on their businesses to also assess how their own activities affect external social, economic and environmental systems. The new rules mandate companies to have regular dialogue with their investors in the whole area of corporate social responsibility.

Separately, other rules are in place to mandate banks and insurance companies to have strategies to reduce the carbon footprint of their emission-financed asset portfolios in line with national goals. All these measures are backed by the world's largest energy trading system for the Chinese power generation sector and likely to be extended to other sectors before long. The country now leads the world in solar and wind power.

Welcome though these measures are, we remain concerned about the heavy-handed approach of the state towards the private sector. Consumer confidence has nose-dived. Lack of data transparency makes it hard to assess the true scale of the challenges China faces.

A French pension plan

Investing will rely on a range of methods

On a three-year forward view, the survey respondents expect to deploy a variety of methods to invest in Asian emerging markets. Each method seeks to target different benefits – via active or passive funds (Figure 5.3).

Taking them in turn, the most popular method is likely to involve active investing, via their external asset managers, in Asian companies listed in Asian emerging markets (49%). It is seen as being conducive for harvesting alpha opportunities by focusing on the intrinsic worth of the assets and their capacity to generate good shareholder returns in a risky environment. Direct investing also permits respondents to exercise their stewardship role more effectively, especially in the ESG space. This is in marked contrast to the previous belief that the region's favourable growth dynamics will automatically generate attractive low volatility returns. That outcome has not been experienced widely, as seen in Section 4. It is no longer taken for granted.

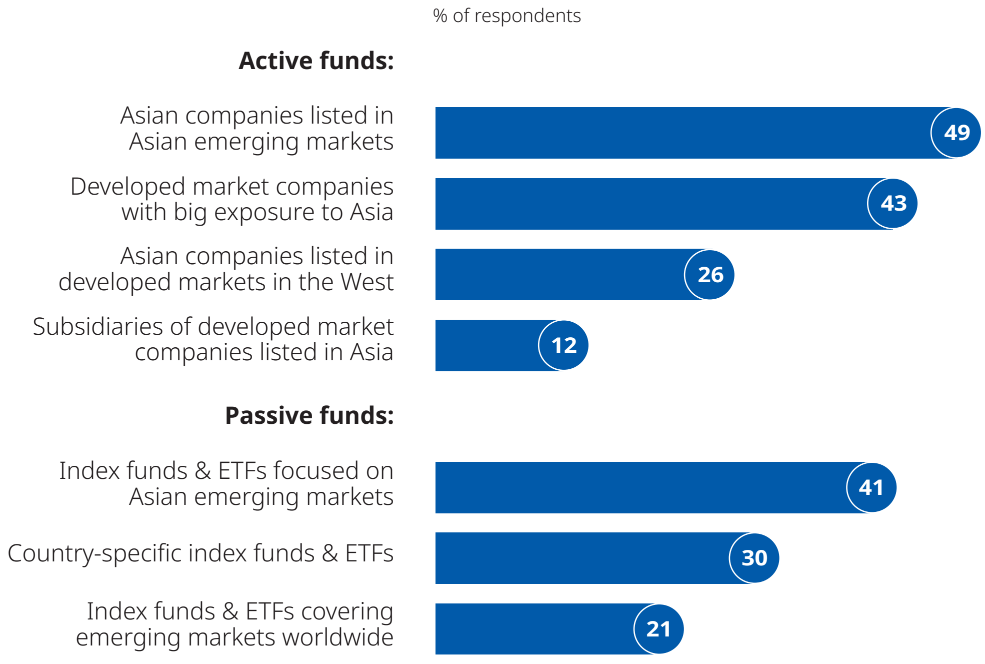
Direct investing also permits respondents to exercise their stewardship role more effectively, especially in the ESG space.

Another method for targeting alpha will likely involve investing in developed market companies with high revenue and profit exposure to Asian markets (43%). This will be favoured by those respondents who also want ample liquidity and the lower volatility provided by developed markets. For them, such companies receive so much revenue from emerging markets that their formal domicile is not of much relevance. This consideration applies particularly to companies with high exposure to China.

In reverse, some respondents prefer to invest in Asian emerging market companies that are listed in developed markets in the West (26%). The advantage of this approach is that such companies are expected to have corporate governance, transparency and reporting practices consistent with the developed market listing laws with which our respondents are familiar.

A small minority are also likely to invest in the subsidiaries of developed market companies listed in Asia (12%). This is in the belief that such subsidiaries will have

Figure 5.3 **Which principal methods will be used by your pension plan for investing in Asian emerging markets over the next three years?**



Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"High conviction investing is the best way to achieve good consistent returns in Asia."

"It's a lot cheaper to invest in developed market companies with high exposure to Asia."

governance, transparency and reporting practices similar to their parents.

Turning to passive funds (Figure 5.3, lower panel), broad-tent index funds and ETFs focused on Asian emerging markets top the list (41%). A subset of that will overtly seek to exclude China and seek to follow specific themes, especially ESG. China's volatility and subpar returns over the past decade have been a drag on the overall performance of these broad indices, given the largest weight of China in equity indices at the time. Just as investors have long preferred 'Asia excluding Japan' funds, a similar fate is likely to await China. That overweight position only delivered stellar returns for broader equity indices until 2010. The same cannot be said of fixed income indices where the China weight has been a lot lower.

Dispersion within these broad EM indices between the best and the rest remains wide, and the turnover of companies high in the periodic rebalancing.

Indeed, the China exclusion process has already reached the point at which countries like India and South Korea are already attracting interest via single country indices and ETFs in the interest of extreme selectivity (30%).

As a result, broad-tent index funds and ETFs – embracing emerging markets worldwide – are likely to be used much less (21%). Once touted as the key low-cost vehicle for going into emerging markets, such funds are losing their appeal by not considering the growing intercountry differences of their constituent companies. Besides, dispersion within these broad EM indices between the best and the rest remains wide, and the turnover of companies high in the periodic rebalancing.

Overall, both active and passive funds are likely to be used in different guises. However, concerns have arisen over the new bipartisan anti-China measures that are now being considered by a select committee of the US House of Representatives (see INSIGHTS). They aim to exclude China from all the key market indices and, by extension, from index funds, and require said funds to divest from such investments within 180 days of enactment.

The stated reason is that such funds do not perform adequate due diligence on the unique risks inherent in Chinese companies and the threat they pose to retirement savings. The similar exclusion of Russian securities in the wake of the invasion of Ukraine inflicted severe losses on investors. For now, the final shape and timing of legislation is unclear. But it may well impose another layer of risk in investors' Asia portfolios.

Interview quotes

"Passive funds require minimum governance, as they offer a set-and-forget autopilot option."

"Passive funds are likely be narrow in their country coverage so as to capture the differences in progress between countries."

INSIGHTS

Chinese securities face exclusion from index funds

One visible sign of the deteriorating relations between China and the US is a package of bipartisan measures now being considered by the US House Committee on Financial Services. Two of the measures will affect pension investors.

The most far-reaching measure is the No China Index Funds Act. It requires funds that track a market index to exclude all Chinese securities. Evidently, due diligence in such funds does not factor in the unique risks of Chinese companies, as is currently the case for actively managed funds. The scope of the proposed act is broad: it applies to indices entirely focused on Chinese securities as well as those broader indices containing Chinese and non-Chinese securities.

Another measure is the No Capital Gains Allowance for American Adversaries Act. It aims to remove the tax break for investments in companies based in Belarus, China, Iran, North Korea and Russia. The stated aim of these and other measures is to prevent American investors' capital from funding China's military technologies, environmental damage and human rights abuses. The proposed package had bipartisan support. The anti-China stance of the new US administration indicates that President Trump is unlikely to exercise his veto.

Seeing as Russian securities became worthless when the country was excluded from the main indices, the new measures – if enacted – will make Chinese securities even more volatile. For now, we are reducing allocations to all index funds.

A US pension plan

Manager selection is focused on two sets of criteria

It is now widely accepted that the battle against climate change will be won or lost in Asia.

For most of our survey respondents, the downside risks inherent in Asian markets are only exceeded by the upside potential. Favourable growth dynamics and corporate reforms aside, Asia has been a relative latecomer to the ESG space and can potentially offer big investment opportunities.

Until recently, Asian countries prioritised raising their living standards over environmental protection by measures that overly rely on high carbon-emitting industries, such as aluminium, cement, coal and steel. With the rising frequency and ferocity of extreme weather events, the scales are now tipping the other way. It is now widely accepted that the battle against climate change will be won or lost in Asia. This is duly reflected in the criteria used by our respondents when awarding Asian asset mandates to their external asset managers. In particular, they are paying special attention to two sets of selection criteria: past track record on various aspects to demonstrate that they are capable of meeting their clients' goals; and a suite of capabilities to ensure that their track record has a higher likelihood of being replicated in the future.

Taking them in turn, as Figure 5.4 (upper panel) shows, delivering clients' financial and ESG goals top the list (63%). This emphasis on triple bottom line reflects the view that the region, as a whole, is not only becoming investor friendly; it also offers prospects of 'green' alpha.

Harvesting that requires asset managers to act as credible stewards of their clients' assets by engaging with their investee companies, tabling shareholder resolutions, proxy voting and working with other shareholders to deliver the triple bottom line (55%). Stewardship is seen as the linchpin of ESG investing (see INSIGHTS on the next page). It supports progress on investment themes favoured by the region's growth dynamics (51%).

Figure 5.4 **When selecting external asset managers for investing in Asian emerging markets, which criteria does your pension plan use?**

Source: Amundi Investment Solutions / CREATE-Research Survey 2024

Interview quotes

"Asian nations are trying to catch up with their Western peers on ESG issues, after suffering huge environmental damage from over-rapid growth."

"Our manager selection process is now more evidence based than ever. 'Trust but verify' is our guiding principle."

Past track record in these areas has to be evidenced by a widely admired thought leadership brand on the region's growth dynamics (47%) and a favourable consultant rating (46%). Third-party verification of past track record has become essential.

Respondents are also ascertaining whether a manager has the capabilities that can provide a proxy indicator of future replication (Figure 5.3, lower panel). A value-for-money fee structure tops the list (59%). An ideal structure should have a performance fee with a realistic hurdle rate, so as to ensure an equitable sharing of gain and pain. This need was reinforced by subpar returns suffered during the 'lost decade'.

Third-party verification of past track record has become essential.

A deep talent pool capable of delivering innovative client solutions is next on the list (57%). As our respondents become more selective via concentrated high-conviction portfolios, they want to be assured that their portfolio managers are not only well versed in the financial aspects of investing but also in the cultural and political nuances of the countries concerned. To reinforce that, managers are also expected to have a strong physical presence or joint ventures on the ground (56%). Either way, politics as much as economics drives national markets. A more holistic approach to investing has a better chance of success.

Next on the capability list is accurate timely information (49%). The reporting requirement here is not only for financial results but is also for stewardship activities and ESG outcomes. Finally, managers are enjoined to be part of global advocacy groups – like Climate Action 100+ and UNPRI (41%). The aim is to have extra leverage when dealing with portfolio companies on ESG issues and to influence public policy on ESG.

Overall, the foregoing criteria underscore two imperatives in manager selection: to secure a financial as well as a sustainability-based alignment of interest; and to ensure that the next wave of Asian growth has a clear qualitative dimension.

Interview quotes

"ESG is not about advancing a social agenda but achieving return targets by investing in businesses that are future-proofing themselves."

"There is nothing one-size-fits-all about Asia. Our ESG goals call for active stewardship on the part of our asset managers."

INSIGHTS

Corporate stewardship is foundational to Asia investing

With its huge diversity in corporate practices and national cultures, sustainability investing in Asia requires impactful stewardship.

Our investment goals require the investee companies to have clear ESG targets, sound action plans, credible outcome metrics and meaningful timelines. We use stewardship to provide not only an oversight framework, but also as a vehicle for influencing business strategy and ESG progress, thereby securing a greater alignment of corporate and shareholder interests. We only invest in companies that we can help to migrate from 'dark brown' to 'light green' to 'dark green'. We draw a line in the sand about critical metrics like their carbon footprint, board composition and governance practices.

When selecting external managers for Asian investing, we look out for two sets of attributes: leadership and operational. Both envisage asset managers going from a distant vendor to a strategic partner: somebody who is in their clients' inner circle of confidants.

On the leadership side, we assess the extent to which business leaders at asset management firms set the 'tone at the top'. This is done in two ways: first, by creating a culture in which ESG is not just another fad but a step change in the way investing is to be done; and second, by harnessing the collective expertise of the investment team and the stewardship team.

On the operational side we look for a strong track record on engagement, proxy voting and ESG impacts on top of financial outcomes. We especially look out for their record on the double materiality principle: how investee companies are protecting their business against ESG risks; and, in turn, how their own business operations are benefiting the natural environment and wider society.

This also gives managers an information edge by having a clear view of how the ESG agenda is actually playing out on the ground. This is all so different from the past where we went through too many managers, with results barely distinguishable from a broad index.

A Danish pension plan

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[1] Source: IPE "Top 500 Asset Managers" published in June 2024, based on assets under management as at 31 December 2023

[2] Amundi data as at 30/06/2024

[3] Boston, Dublin, London, Milan, Paris and Tokyo

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