The Investment Podcast

Episode 20: The Investment Podcast: Key growth drivers for private markets
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Romil Patel: Hello, and welcome to this episode of *The Investment Podcast*. My name is Romil Patel, and today I'm joined by Will Nicoll, chief investment officer for private and alternative assets at M&G Investments. Welcome Will, great to have you here today.

Will Nicoll: No, thank you very much, good morning.

Romil: Good morning. The world of alternative assets is gargantuan with assets under management topping $13 trillion in 2021, and it's estimated that this will surpass $23 trillion by 2026, according to Preqin. However, today's global picture is complicated with risk aplenty, and in this instalment, we'd like to look at what this means for the world of alternative assets. Will, as inflation in major economies sets 40-year highs, we're in deeply negative real interest rate territory, the dominant theme of 2022, what does this mean for investors in private assets?

Will: That is the question. It is very difficult to really try to work out exactly how that's going to play out. I think if you look at any particular markets at the moment, we have not seen the yield curve and the fixed income markets look quite so different to the inflation outlook. I certainly can't remember that in my working career, and I think it's quite difficult to see that when you go back in history. I think to try to speak with certainty about what that is going to mean for investors in private assets I think is extremely difficult.

The one thing I would say is that, as you said, the private asset markets are extremely wide and growing strongly, so whether we are thinking about something like infrastructure debt that may well have an inflation linkage in various different ways and therefore you have an extremely attractive outcome for investors, certainly compared with fixed-rate assets, even down to most standard private assets are actually in the debt side of floating rate, and then again, that gives you quite a good amount of protection against rising interest rates, all the way through to real assets.

You've got the various real estate markets that presumably over time will have a linkage through to inflation, although clearly, that's not one for one as you go forward in the next couple of years. Through to distressed markets through distressed markets, the difficulty with the question sadly is that there's such an enormous width of different assets, you're bound to find some that I think will do very well in a period of slight confusion, and in a period where if people are less willing to take risk, you should see some quite interesting prices coming through, which we're already starting to see. Through to other areas where you may see that people have slightly overextended themselves over the last few years when money was extremely cheap and where leverage might have been a bit high, and therefore, you might see some parts of the corporate market where highly levered corporate balance sheets may not be able to cope with an environment raising rates, and certainly with an environment that might seem a little bit more recessionary.

The answer is it's not quite as simple as saying it's all going to be good or it's all going to be bad, it's going to be incredibly mixed across the whole area, and it requires everyone to have a very deep idea about what each asset class is trying to do, and what the drivers behind each asset class are.

Romil: That inevitably begs the question, how do investors make sense of what is a very broad asset class?

Will: Yes, and I think there's are two or three ways of doing this. The first way is that as an investor, if you have a very clear view of what you're trying to achieve, then I think private assets can be extremely helpful. So if, for example, there is a return over a particular period of time, then private assets by the very fact they tend to be illiquid and tend to be quite specific in the areas that they are approaching, means that you can end up building a portfolio either of debt or private equity or of real estate that would look to try and achieve those aims. I think that that's one area, so that's clearly easier in some ways.

If on the other hand, you are looking at some just profit maximisation, then it comes down to, I think, a more thematic view of where you see that the risks are allowed to come through over the next few years and therefore, which bits of the markets might or might not have overreacted. The slight difficulty here is that all private markets will move normally slower than the public markets, but equally, some will move faster than others. For example, if I look at the ABS market, the asset-backed security (ABS) market in the public side clearly has reacted already in the same way as public markets have.

The private ABS market has therefore also moved at the same pace, so in that case, if you see that there are some reasonable value coming through in the public side, then on the private side, that's come through too. When you look at some other markets, then it takes a little bit longer for the various different views to feed through. A lot of private assets may have a three to six-month lead in time – then you would expect to see the pricing gradually adjust as we work out whether the recent turbulence in public markets is short-term or is actually going to be a little bit more long-term, at which point the assets come out.

There's definitely a timing issue that one has to look at. I think that clearly as fund managers, part of our role is to make sure that we are always looking out for that timing and looking out for when the value approaches because we know it's impossible to know exactly what's going to happen in the future. But certainly, it is quite a lot easier to see where value is turning up, and where value is appearing, and that at the moment, because of the way the world is, that tends to be in the asset classes that are more linked to public assets, but that will shift dramatically over the next couple of months depending on where the public asset markets go.

Romil: It's fair to say that timing in uncertain times will involve deft risk mitigation. What are some of the top risks on your radar, and how are you managing these?

Will: The interesting thing with private assets tends to be, if you're going to be limited in being able to sell them, then almost the whole discussion is about risk mitigation because once you bought an asset, in general, you're going to be holding it, and in general, if you've got the risks right, then that will be quite calm, and if you've got the risks wrong, then you'll be working quite hard to make sure that you're mitigating them as they go through.

In terms of risks for any assets, any illiquid assets, you're always looking at interest rate risk, and whether you've mitigated that, and as I say, a lot of the private markets are floating rates, so in many cases that's not so important. You're also looking at financing risk, so in quite a lot of cases – and we tend to do a lot less of this – but in a lot of cases, there's actually been leverage placed on private asset markets, and so the availability of leverage or the cost of that leverage coming through, I think that is also something that to the private asset markets as a whole is going to be quite important.

As I say, that's not something that we tend to do in most markets, and therefore, I think that's less of an issue for us. Then, you do have the geopolitics which drives everything in the end. Firstly, the simple geopolitics in terms of access to markets and access to areas. We, for example, do quite a lot of assets in emerging markets, in impact in emerging markets and therefore, you need to be very careful to look at any global themes that are changing the risks associated with investing in those markets.

Then, there's the next element of the private markets, which I think is also fascinating in that a lot of the new technologies, a lot of the ability to transform our economies into a very much more carbon neutral or even carbon negative outcome are going through the private markets. Whether that's private equity or whether that's private debt, many of those companies aren't yet at the sort of size that would go to the public markets.

You have another whole set of risks or opportunities with dealing with how emerging technology is going to disrupt either some of the assets you've already got in, for example, some of the infrastructure space, or whether you are going to be able to get the super-normal returns that you'd expect to get from investing in more exciting parts of the market where things aren't developed.

Romil: Just staying on the subject of impact, Will, as we mentioned earlier, assets under management in alternatives are projected to surpass $23 trillion by 2026, that's a growth of just under $10 trillion in 5 years, according to data provider Preqin. Just how sizeable is the opportunity to address lasting positive impact via private markets given the long-term time duration of strategies and also the nature of close engagement with investee companies?

Will: I think that's a great question because the answer is that it is almost impossible to overstate I think how important private markets are going to be to impact, and therefore, how much impact investment is, in the other way, going to have to go through private markets. I think part of that comes from just the structure of the markets. If you think about public markets, then that tends to be dealing with larger companies, certainly on the debt side, and they tend to be companies with multi-strategy. Whereas if you think about the private side, you end up with quite a lot of assets that are either single-strategy or are projects that you can very clearly delineate and measure.

If we think that one of the most important things about impact is to be able to measure what that impact is, then I think you end up being driven down the route of private markets. That also means that as we deal with smaller companies, we're able – as well as with the interactions that we have and the engagement that we have – to drive governance and to drive social agendas as well, which I think is also very important because a lot of these companies will end up being large multinational public companies I'm sure at some point, and so the help that we can give them to start with in terms of where we think their governance should be or what social aspects they can add.

I think the other thing about the private markets is because you tend to be getting quite early, you can do things that I think just probably aren't available elsewhere. When I think about our investment into carbon-negative housing, that's just not something that's available in the public markets at the moment, or if you think about carbon capture. Through our catalyst funds, we've been able to invest in some really very early-stage companies that are doing things that could fundamentally change the way that either climate and the various other problems there work, or indeed social ideas such as housing and climate together when you think about carbon-negative housing.

I think that's one of the big growth engines of private markets over the next 10, 20 years. If you think about the private markets as a whole, there's really only two big drivers. The first driver is you're still seeing banks changing what they're doing, and you're still seeing the market – certainly in Europe – absorbing that area away from the banks, and I think making a more robust whole set of capital markets, but the other driver that we have is clearly impact, watching as investors become more and more serious about making sure that their money is having a measurable and positive impact on the world.

I think that those two things together means that you're going to have growth of the private markets over the next 5, 10 years, just in the way the banks are moving. From the impact discussion, then you're going to have a growth driver over the next 20 years as we look to try and fundamentally change quite a lot of the economies of the world. This is a significant and real shift that's going to require a lot of money, and it's going to require a lot of money to take a bit of risk in terms of working out what the future technologies are and how they're going to work best and how that's going to fit in with the established markets.

Romil: Finally, before we go, Will, I'd be remiss if I didn't ask you for your final thoughts as we enter the second half of the year. Over to you.

Will: I think that the world is in a really quite extraordinary place. It is very, very rare, as I said before, to see interest rates and inflation and growth all looking the way they do and looking completely out of kilter. Everybody who's listened to this will understand that it's very difficult to see where to invest and how to invest. When you look at the public markets and the private markets, there are areas as we well know that will be extremely successful over the next 5, 10 years.

Therefore, the way that I'm looking at it is that a lot of the change that we're going to see over the next 5 or 10 years, whether that's in impact, whether that's in climate, whether that's in emerging technologies, whether that's in energy, are going to come through the private markets, and they are going to be areas that are developing fundamentally over the next 5, 10 years, which will be extremely good investments. It may be more difficult to see it at the moment.

I think also that when you look at some of the existing investments, we're in a period of volatility, and periods of volatility clearly throw up opportunities as well as regrets. I think it's all quite exciting. I think we are in a very interesting position where it is not clear exactly how central banks are going to work. It's not clear exactly whether we're going to go into a recessionary environment or not. It's not clear because we haven't done QE before how quantitative tightening is going to happen. Each of those things is adding volatility to the markets, and therefore, opportunities are appearing already.

There are going to be significant opportunities coming through over the next one or two years, which will produce investments that will be extremely attractive and beneficial for investors coming through over the next 5, 10 years following. As I say, the most important thing at the moment is to be opportunistic and is to be very aware of what you're investing in, and I think in the private markets, particularly why you are investing in that area.

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Romil: Well, sadly, that's all we have time for in today's episode of *The Investment Podcast*. Thanks indeed to Will Nicoll, CIO of Private and Alternative Assets, for sharing his perspectives, and indeed to you, our audience, for tuning in. Until next time. It's goodbye for now.

Speaker 2: This podcast is for investment professionals only. For further information, please view the notes which accompany this episode. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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