Spectrum

Have alternatives gone mainstream?

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Federated Hermes Limited

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Opportunities in private markets

Private markets' inherently long-term outlook allows investors to dampen but not remove some of the volatility that can characterise public markets and stay focused on the fundamentals of any business.

Private markets have expanded and matured over the last decade and now make up a significant aspect of global finance, accounting for almost a tenth of global investable assets[1]. Many investors have become much more open to a trade-off: less liquidity in exchange for higher risk adjusted returns in longer-term investments such as real estate, infrastructure, private equity and private debt.

The challenging backdrop facing public markets this year – which has seen global stocks and bonds fall in tandem – has helped burnish private markets' appeal. The FTSE All World stocks index had dropped 22.39% year to date as at 22 September while returns on the Bloomberg Global Aggregate Bond index was down 18%[2] on the back of soaring inflation, rising rates and the war in Ukraine.

Private markets' inherently long-term outlook allows investors to sidestep some of the volatility that can characterise public markets and stay focused on the fundamentals of any business. There is no need to respond to real-time ticker feeds.

Private investments are, of course, not immune to the macro backdrop. Factors such as inflation and rising rates still have an impact, they just take longer to feed through. The lack of tradability in the asset class means there can be less pressure in the system. As a result, investors can have more certainty about the valuation of a particular holding.

These characteristics can, of course, count as weaknesses as well as strengths. The illiquid nature of private markets can slow efforts to address losses and a lack of market prices can sometimes lead to opacity around purchase valuations.

Cautious outlook

These concerns have not stopped the growth in private equity deals. The global value of disclosed leveraged buy-outs reached $1.2tn in 2021 and private equity made up a fifth of all mergers and acquisitions, its highest share for at least a decade[3].

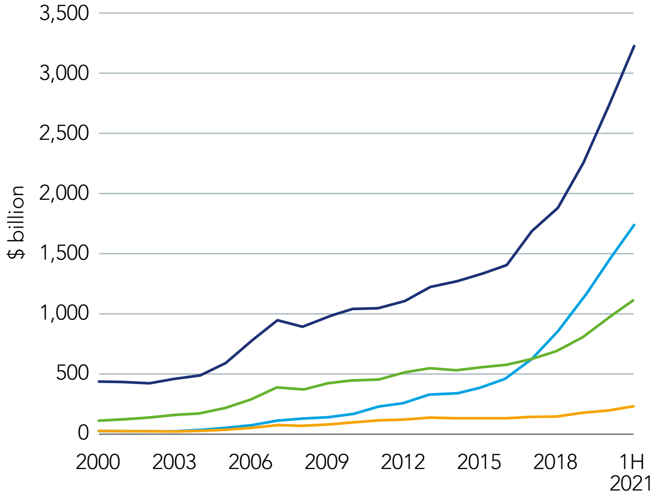
However, private asset transactions slowed in Q2 and Q3 of this year, as market dynamics hindered dealmaking. Firms are being more cautious about deploying significant dry powder – committed, but unallocated capital – in light of market volatility and rising interest rates. Meanwhile, funds seeking asset sales, particularly open funds in real estate looking to meet redemptions, are facing falling pricing.

The turmoil in public markets makes the 'denominator effect' likely to impact allocations to private market strategies in 2023 as investors seek to re-balance their portfolios. However, the current market volatility should create future investment opportunities, an environment arguably not seen for many years.

Many investors have become much more open to a trade-off: less liquidity in exchange for higher returns in longer-term investments such as real estate, infrastructure, private equity and private debt.

[1] Private markets are less rewarding than they used to be | The Economist
[2] Bloomberg as at 22 September (US dollar basis)
[3] Private markets have grown exponentially | The Economist

Figure 1: Private equity's impressive growth rate



	2016-1H 2021 %
North America	20.2
Asia	34.5
Europe	15.7
Rest of world	13.4

Source: McKinsey & Company / Preqin

Nonetheless, a rise in inflation can benefit some private assets, such as infrastructure, which can have a contractual or regulated linkage to inflation.

Prior to the 2008-09 financial crisis, private credit was typically found on the margins, catering to various niches. The subsequent onset of capital requirements and regulations has led traditional banks to back away from areas such as property lending, particularly for construction and refurbishment, creating opportunities for non-traditional lenders. The private-credit market has more than doubled in size since 2015 and is now worth at least $1tn worldwide[4].

Despite the downturn in the economy this year, there also remains huge demand for real estate debt with the current environment adding to the appeal of the asset class. As rising rates put upward pressure on real estate yields, an allocation to real estate debt as part of a wider property strategy can actually help investors reduce the impact of real estate yield widening on an overall portfolio return, while still maintaining exposure to the income that real estate assets generate.

The current market volatility should create future investment opportunities, an environment arguably not seen for many years.

[4] More borrowers turn to private markets for credit | The Economist

Time, diversification and a tailored approach

Benedetta Balducci, Head of Portfolio and Client Solutions EMEA, Private Equity

There are a number of ways in which private equity assets can respond to and mitigate what's going on in the wider market.

We are in the midst of a unique market environment, dominated by unprecedented levels of uncertainty.

Volatility and inflationary trends have undermined market confidence, and the prolonged underperformance of key public asset classes has made investors uncertain about asset allocation over the medium- to long-term.

Meanwhile, the key attributes of private equity, and private markets generally, can provide a number of benefits for investors at the present time.

Private assets, by their very nature, are not constantly being valued and marked to market up-to-the-second and instead, typically respond to public market fluctuations with a lag of a three to six months.

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This lag not only reduces volatility in reporting, but also allows managers in the private market space to work on corrective measures aimed at mitigating or better responding to the new challenges showcased on public markets, or even to slowly adapt and course correct – when those changes seem to be longer lasting.

Private holdings allow investors to remain focused on long-term market goals – with managerial corrections and growth strategies implemented over five to ten-year time horizons – even when trading conditions become difficult and public firms seek quick wins to keep shareholders happy.

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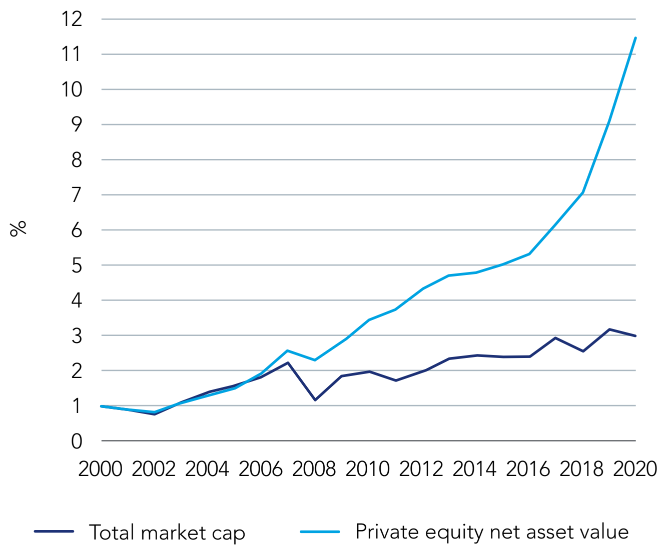
During the Covid-19 pandemic, many private equity general partners (GPs) worked closely with their portfolio companies to review and anticipate potential supply chain disruptions and were able to implement such changes throughout 2020 (even before the deteriorating performances were published for the first two quarters) and 2021.

In these circumstances, unlike the mass sell-offs in public markets, many private investors found themselves stuck with sizeable holdings in underperforming private companies (especially following Q2/Q3 2020 valuations), but some were rewarded with attractive surges in profitability just six months after the end of lockdowns, and are now benefiting from longer-term holdings.

Figure 2: Private equity net asset value has outpaced total market cap of listed companies in recent years



Source: McKinsey & Company / Preqin

Real estate debt at a time of rising rates

Vincent Nobel, Head of Asset-Based Lending

In the current environment, the relative value of real estate debt looks attractive

The current environment of inflation and rising interest rates has a profound effect on pricing of real estate and real estate debt. Traditionally investors have valued real estate by comparison to the risk-free rate, with a premium applied to allow for the risk associated with holding real assets, the illiquidity of these assets and the depreciation of physical buildings. Though real estate loans are typically agreed for periods of three to five years, it is the ten-year government bond yield that is used as the risk-free rate benchmark in fair value analysis, because it has a similar maturity profile to prevailing lease lengths of prime property.

During the global financial crisis (GFC) property values fell in every market. Combined with monetary policy putting significant downward pressure on bond yields, real estate looked attractively priced in the aftermath of the crisis. Continued monetary tightening pushed bond yields lower than ever before, so even with significant property yield tightening in the years after the GFC, real estate looked relatively attractive for an entire property cycle (around the last 15 years).

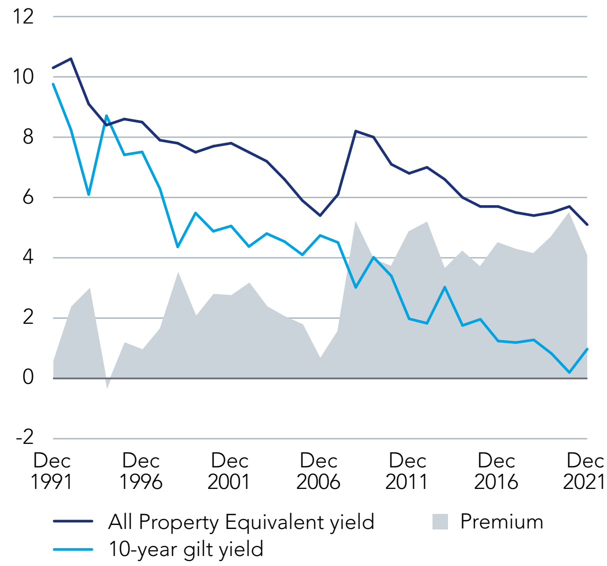
Figure 3 shows that the average premium for holding real estate rose from approximately 190bps to 440bps in the post-GFC years. However, on an absolute basis, returns have been low, which has made cheap leverage an attractive option for many investors.

However, at the present time we find ourselves in a rapidly changing rate environment. Inflation in many countries is at its highest level for more than 40 years. We are seeing inverted yield curves. In response to inflation, central banks are aggressively pushing up rates.

Traditionally investors have valued real estate by comparison to the risk-free rate, with a premium applied to allow for the risk associated with holding real assets, the illiquidity of these assets and the depreciation of physical buildings.

In the current environment, the relative value of real estate debt looks attractive. Rising rates puts upward pressure on real estate yields. As can be seen in Figure 3 the real estate market may lag a little (as it did in 2007) but in the end investors will require a premium for holding real estate assets compared to government bonds. In times of low growth (and certainly in a recessionary environment), rental growth will be harder to achieve, and therefore upward yield pressure should result in capital value decline for real estate owners.

Figure 3: Real estate yield premium



Source: MSCI Real Estate / UK Office for National Statistics
Past performance is not a reliable indicator of future performance.

By making an allocation to real estate debt as part of a wider real estate strategy, investors can reduce the impact of real estate yield widening on their overall portfolio return, while still having exposure to the income that real estate assets generate.

Affordability key to stable long-term returns

Will Gibby, Director: Fund Management – Global Residential and International Real Estate

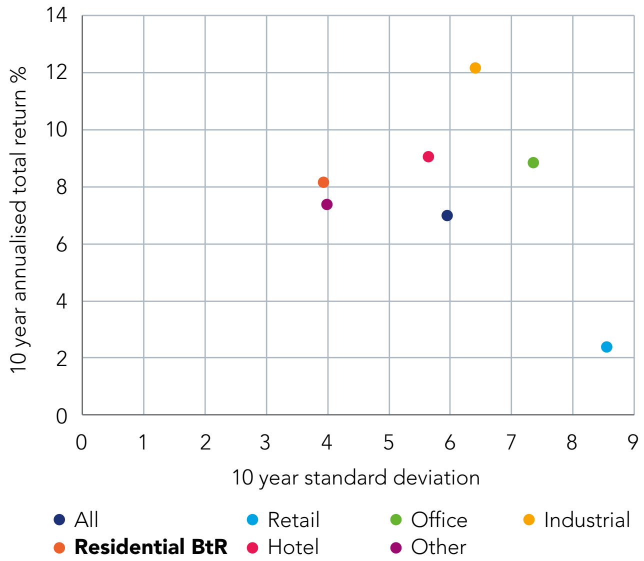
Build to Rent (BTR) schemes offer purpose-built housing designed for rent rather than sale to meet a gap in the market.

The average number of new homes built in the UK today is half the level of the 1960s and 1970s[5]. At the same time there has been significant population growth, the UK population has increased about 20% over the last 50 years[6]. On top of this, people typically get married a lot later, and many more people live alone. The net result of all of this is a persistent housing deficit.

Build to Rent (BtR) schemes offer purpose-built housing, designed for rent rather than sale. A typical scheme might have 200-350 apartments, with communal facilities (such as co-working areas, residents lounge or gym) and benefit from on-site concierge, management and maintenance teams. The focus is on customer service and creating a community for residents, which results in higher retention rates and ensures a robust and sustainable income for our clients.

Federated Hermes have been investing in BtR on behalf of our clients for approximately nine years, primarily in the UK however we also have interests in the US, Australia and previously mainland Europe. The reliable income stream, collateralised across a large number of occupiers, also benefiting from a low correlation to commercial property markets – has made it an attractive asset class for our clients. BtR offers one of the best risk-adjusted returns of all the property sectors.

Figure 4: UK residential Build to Rent (BtR) vs. other property sectors



Source: MSCI as at December 2020
Past performance is not a reliable indicator of future performance.

Hestia is Federated Hermes' operational platform, managing the operational assets and the development pipeline of our clients. Hestia offers a mid-market product (typically 10-15% below prime rental values), which benefits from the widest pool of demand. Our proprietary database guides investment into local markets and mitigates locational risk, while our specification, policies and procedures mitigate development risk in the forward funding process and ensure assets aren't stranded in the future.

For obvious reasons, operational performance of a BtR asset is the key driver of capital value, therefore our vertically integrated team is instrumental in delivering out-performance for our clients from the design process through to the ongoing operation of the assets.

[5] Fewer houses have been built in the past decade than any since World War Two, figures reveal | The Sun
[6] U.K. Population 1950-2022 | MacroTrends

Energy transition driving infrastructure sector boom

James Wardlaw, Partner – Infrastructure

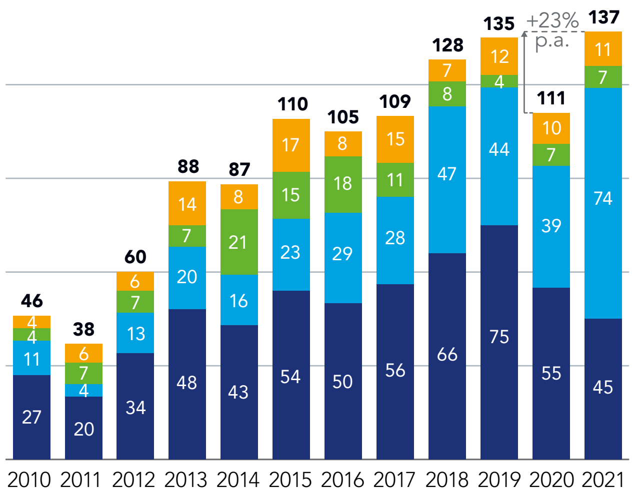
Many infrastructure assets have a contractual linkage to inflation, but the rising interest environment will begin to adversely impact valuations.

Energy markets and the related 'cost of living' crisis is undoubtedly causing hardship in the UK and elsewhere but in two respects, infrastructure assets are the beneficiaries:

- Infrastructure is central to the transition to net zero. The infrastructure sector – through energy, transport, water, waste management and digital communications – accounts for 62% of global greenhouse gas emissions, according to the United Nations Office for Project Services.
- There isn't going to be an energy transition if we cannot achieve decarbonisation via infrastructure and this realisation is driving a lot of investment opportunities at the present time. It's one of the reasons why the infrastructure sector is 'hot' at the moment and is likely to remain so.

Another factor is inflation. The majority of our assets have a contractual or regulated linkage to inflation – the revenues are uplifted by the consumer price index (CPI) or the retail price index (RPI). I'm not going to express a view on where inflation will go over the medium- to long-term. But if you anticipate higher-for-longer inflation, it adds to the attraction of infrastructure as an asset class.

Figure 6: Infrastructure funds hit an all-time high in 2021

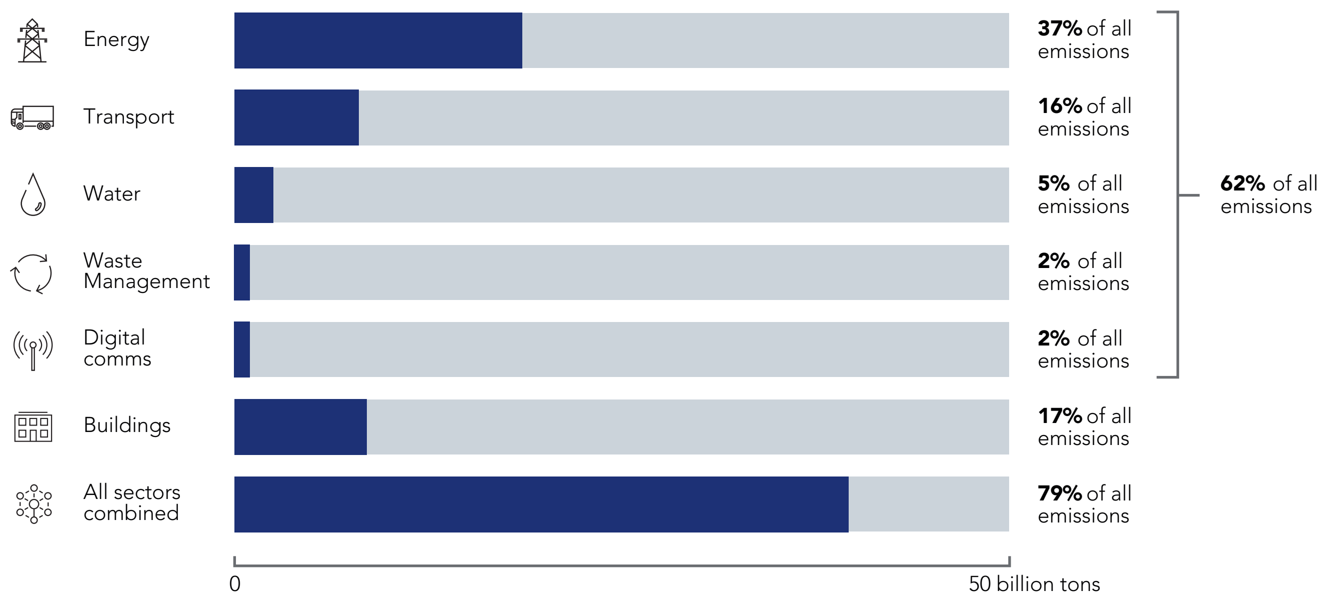


	2016-21 CAGR, %	2020-21 CAGR, %
Total	4.2	23.0
Rest of world	6.5	8.1
Asia	-17.9	-8.6
Europe	20.4	87.7
North America	-1.8	-16.8

Source: Preqin, McKinsey & Company

The infrastructure team at Federated Hermes manages about £3bn of capital across co-mingled funds, segregated and managed accounts.

Figure 5: Infrastructure is central to the transition to net zero



Source: United Nations Office for Project Services

Supply chain snags offer huge opportunities

Chris McGinley, Head of Trade Finance

Amid an uncertain economic backdrop, a diversified pool of trade transactions has the potential to deliver the kind of 'pure alpha' that many investors are searching for.

As countries around the world emerge from the Covid-19 pandemic and grapple with the fallout from the Ukraine conflict, trade finance has a critical role to play in addressing snags in global supply chains and ensuring that vital commodities continue to flow.

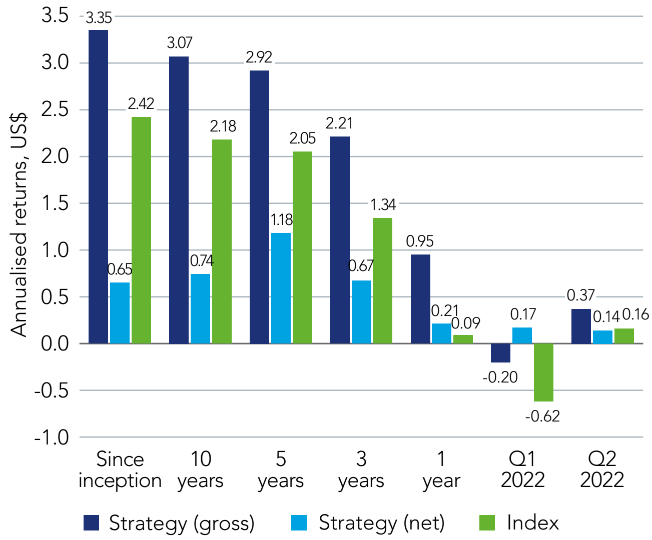
While many in the West often associate imported goods with high-end items, for much of the developing world such shipments cater to more basic needs, such as the import and export of basic foodstuffs.

Trade finance, essentially short-term loans to facilitate physical cross-border transactions, can play a crucial role in reducing risks and reconciling the divergent needs of an exporter and importer by introducing a third-party to transactions to mitigate the payment risk and supply risk. It provides the exporter with receivables or payment according to the agreement while the importer might be extended credit to fulfil the trade order.

The loans, which are made to finance a specific transaction, are collateralised by the goods being financed and are self-amortising from the proceeds of the transaction. Risks in any individual transaction can be navigated and reduced; risk mitigation techniques include collateral management of the goods, permanent control of the title over the goods, ring-fencing cash flows and trade credit insurance. The payments, consisting of both principal and interest, are made on a predetermined schedule, ensuring that the loan will be paid off by the end of an agreed-upon term.

Federated Hermes[7] has been offering trade finance in a fund format to institutional investors since 2009. The risks inherent in any transaction are analysed on a case-by-case basis to determine how they can be mitigated, while at the same time ensuring the risk-adjusted return remains attractive.

Figure 7: Federated Hermes trade finance (annualised returns, US$)



Source: Federated Hermes
Past performance is not a reliable indicator of future performance.

Although the demand for trade finance continues to grow, a complex regulatory environment coupled with a lack of understanding of the asset class has contributed to a global shortage of trade financing. The gap for global trade finance opportunities has been valued at $1.5tn by the Asian Development Bank[8] creating enormous opportunities in next few years. Amid an uncertain economic backdrop, a diversified pool of trade transactions has the potential to deliver the kind of 'pure alpha' that many investors are searching for.

[7] Federated Hermes refers to Federated Hermes, Inc (FHI)
[8] Asian Development Bank, 2019 Trade Finance Gaps, Growth, and Jobs Survey.

A long-term income profile

Dermot Kiernan, Fund Director, FHPUT

The FHPUT strategy targets a wide range of carefully chosen properties, including retail, office and industrial units across the UK.

At the Federated Hermes Property Unit Trust (FHPUT), we are focused on securing and enhancing the portfolio's income profile as part of the responsible, active management approach that has delivered long term outperformance to investors. It reflects a strategic recognition that income is the primary driver of long-term returns in UK commercial real estate.

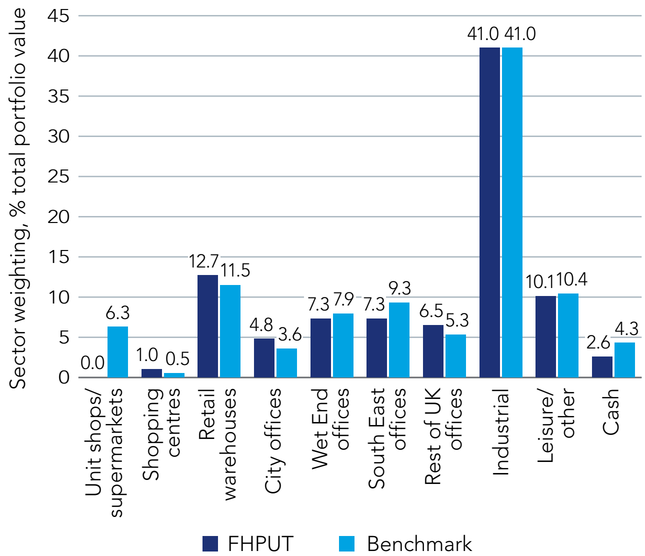
The FHPUT strategy targets a wide range of carefully chosen properties, including retail, office and industrial units across the UK. We select, own and manage all these properties directly.

Our long-term focus is to maintain a balanced portfolio with the potential to grow sustainably, integrating ESG across our activities. We seek to execute well-timed purchases and asset sales, utilising 'on the ground' intelligence, to make the most of cyclical opportunities and stay on top of risks.

The recent sale of a large industrial estate near the M25 capitalised on what has until recently been an extremely hot investment market. Disposal followed completion of the asset plan and the execution of various added value initiatives (acquisition of adjoining ownerships, facilitating future residential use and ensuring almost full occupancy) at a price materially ahead of the pre-sale valuation.

Our industrial assets are a particularly important element of decarbonisation in our net-zero strategy, which has a target of 2035. The large, flat roof areas that are inherent in the construction of industrial 'sheds' are well suited to solar panels, and we are introducing these as part of our ongoing refurbishment programme across the portfolio. The recent rise in energy prices also highlights the economic benefit of renewables to occupiers.

Figure 8: Focus on industrial assets



(Benchmark: MSCI AREF UK Quarterly Property Fund Index)
Source: Hermes Real Estate and MSCI as at end March 2022
Past performance is not a reliable indicator of future performance.

Lower mark-to-market volatility versus public assets

Laura Vaughan, Head of Direct Lending

Direct lending transaction volumes are correlated to the dry powder raised by private equity funds, which currently sits at record highs.

In general, an allocation to a direct lending strategy can benefit limited partners (LPs) from a diversification perspective through its low correlation to other assets in their investment portfolio, lower mark-to-market volatility versus public assets and by offering a lower risk counter-weight to private equity in an alternatives bucket. It also offers quarterly cashflows, making it suitable for liability matching.

In light of current high inflation and recent, and potentially more near-term, increases in interest rates, direct lending strategies could be increasingly attractive for LPs. Underlying assets in a direct lending fund, namely loans, are floating rate instruments, thus providing a hedge against inflation.

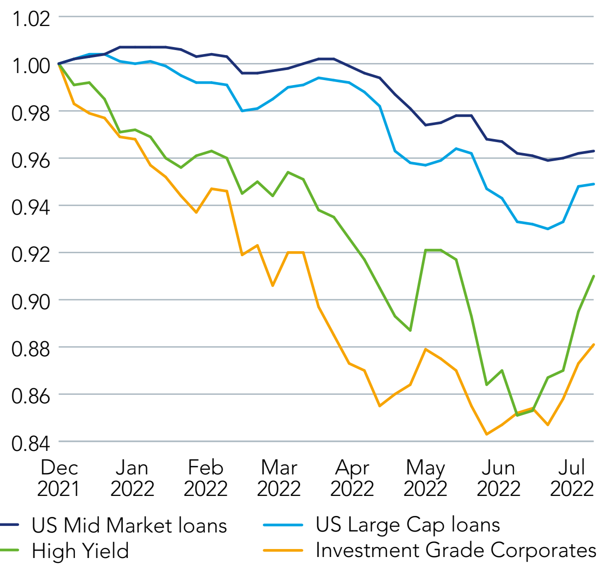
Direct lending transaction volumes are correlated to the dry powder raised by private equity funds, which currently sits at record highs. Therefore, the direct lending market should not experience any significant slowdown in light of reduced economic activity. However, LPs should ensure their manager has a robust origination strategy to enable it to be highly selective and to ensure it can select market leading borrowers operating in more resilient sectors and who are supported by top tier private equity owners.

Considering a manager focused on the European mid-market at a time of heightened uncertainty could prove valuable for various reasons: mid-market loan documentation is more robust than larger liquid loans driven by the negotiating power of fewer lenders in a deal, as well as the dominance of banks who, post 2008, are under more pressure to maintain tougher lending constraints; and pricing levels are more stable, which is also driven by bank lender prevalence and their base line cost of capital.

In light of current high inflation and recent, and potentially more near-term, increases in interest rates, direct lending strategies could be increasingly attractive for limited partners (LPs).

Choosing a senior secured direct lending strategy over a unitranche strategy – which blends safer and riskier debt into a single loan – could, for example, provide LPs with additional comfort. Senior secured term loans, which sit at the top of a company's capitalisation structure, benefit from security of the borrower's assets and, in the event of a default or restructuring, are the first to be paid out with sale proceeds. The quantum of debt relative to a company's total value is materially smaller for senior secured term loans versus unitranche loans, for example, meaning senior secured lenders are supported by larger equity cushions and therefore better placed if company valuations reduce.

Figure 9: Mid-market loans exhibit stability in times of market volatility



Source: S&P/LSTA Leverage Loans Index/ICE BofA
Benchmark source: ICE data indices, llc ("ICE data"), is used with permission.
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Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: