Global Outlook

August 2016

Global Outlook is a monthly publication that contains a series of articles examining markets and key investment trends. In this edition, the interplay of politics and structural issues in economies sets the scene. We then explore the risks and rewards from investing in private and real assets. Infrastructure equity and debt and real estate debt are key components of these markets. We look at portfolio construction and risk management where allocations to illiquid assets are rising.

This document is intended for institutional investors and investment professionals only and should not be distributed to or relied upon by retail clients.

House View

The following asset allocation is based upon a global investor with access to all the major asset classes.

	August 2016 House View	
Risk	The Global Investment Group retains a cautious medium-term outlook, as a variety of political and economic drivers point to higher levels of financial market volatility. While there are particular areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	While the upward trend in wages and tighter labour markets give the Federal Reserve the rationale to raise interest rates gradually, market stress and safe haven flows support Treasuries.	NEUTRAL
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and negative official rates. Political pressures could periodically affect peripheral bond markets requiring a quick ECB response.	NEUTRAL
UK Gilts	The Bank of England delivered significant easing measures, and more may be required in coming months, as political uncertainty related to the EU referendum outcome will cause investment and thus the economy to slow.	HEAVY
Japanese Bonds	The Bank of Japan's sizeable bond-buying programme and negative interest rates have driven valuations into very expensive territory, as the authorities continue to try to reflate the economy.	NEUTRAL
Global Inflation-Linked Debt	While inflationary conditions are globally subdued, markets may react to a rise in headline inflation as the impact of previous commodity price weakness becomes less marked over time.	NEUTRAL
Global Emerging Market Debt	We prefer dollar denominated to local currency debt, both on valuation grounds and on expected dollar depreciation. On a selective basis, higher yields are attractive in an environment of easier monetary policy.	HEAVY
Corporate Bonds		
Investment Grade	Our preference is to be higher up the corporate capital structure. Widening US credit spreads create an attractive opportunity over low-yielding Treasuries; ECB bond-buying programmes support euro debt.	HEAVY
High Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding remains a risk in the US market when monetary policy is tightened. We prefer European debt, which remains supported by yield-seeking investors.	NEUTRAL
Equities		
US Equities	Weaker revenues in key sectors such as energy pose a concern, so earnings management is key. Dividends and share buybacks are still supportive, while valuations have become more attractive.	NEUTRAL
European Equities	Corporate earnings in many European countries will be adversely affected by the uncertainty shock resulting from the UK's referendum, while concerns about banking systems in several countries require careful attention.	NEUTRAL
Japanese Equities	The market has priced in good news in relation to forthcoming decisions on monetary and fiscal policy with the election out of the way. Yen moves are still a primary driver.	NEUTRAL
UK Equities	The economy was slowing already before the result of the EU referendum created additional business uncertainty. Movements in sterling will determine the relative attractiveness of domestically or overseas-exposed companies.	NEUTRAL
Developed Asian Equities	Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China's economic slowdown, especially in private investment, is harming commodity producers and also regional trade.	LIGHT
Emerging Market Equities	There are pockets of deterioration within emerging markets with the commodity price slump badly affecting Brazil, political uncertainty in Eastern Europe, and large behavioural shifts affecting the Chinese market.	NEUTRAL
Real Estate		
UK	The referendum fallout continues to affect liquidity and cause capital depreciation. Income remains attractive versus other asset classes although risks are elevated should conditions turn recessionary or political uncertainty persists.	LIGHT
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by quantitative easing, while recovery plays are showing consistent capital value growth.	HEAVY
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan and Australia, but weakening elsewhere. Emerging Asia markets are risky.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar continues to benefit from safe haven status in times of uncertainty; European and Japanese central banks aim to keep their currencies weak. The EU referendum result is negative for sterling.	HEAVY $, NEUTRAL €, ¥, LIGHT £
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities.	NEUTRAL
Cash		
	US rate rises will be postponed until 2017 at the earliest. Easier policy is expected in Europe and Japan.	LIGHT

Foreword

Editor

Frances Hudson
Global Thematic Strategist

In this edition of Global Outlook, Andrew Milligan, Head of Global Strategy, and Craig Hoyda, Multi-Asset Investing Quantitative Analyst, provide an insight into asset allocation in the aftermath of the UK's vote to leave the European Union (EU). They examine the effects of political uncertainty and stress the need for co-ordinated fiscal policy and structural reforms to address some deep-seated issues facing economies.

The August publication is largely devoted to various aspects of private markets and real assets. By increasing allocations to such assets, investors are targeting illiquidity premiums. Their risk/reward profile is contrasted with conventional markets, which are themselves becoming less liquid.

In Spotlight, I revisit and reassess the arguments for and characteristics of real and private assets, from sustainable yield and relative illiquidity to diversification, in the current environment. I question whether the framework for assessing portfolio risk in public markets is appropriate. Nalaka De Silva, Private Markets Investment Specialist, considers the impact of including more private assets alongside public assets in portfolios. He introduces a new approach to modelling risk, which moves away from mean-variance analysis to consider macroeconomic factors. Advanced cashflow modelling and Monte Carlo simulations are important quantitative elements in reaching a holistic view of portfolio risk.

Dominic Helmsley, Managing Director SL Capital Partners, examines the extensive range of transport infrastructure projects through an equity lens, highlighting the need for robust due diligence and strong sector and local knowledge in order to benefit from potentially superior risk-adjusted returns in this diverse sector. Jeremy Allcock, Head of Infrastructure Debt, provides an in-depth analysis of where privately developed infrastructure fits into the delivery of essential and certain services. The long-term nature of the relationships that underpin such investments is emphasised. Simon Kinnie, Head of Real Estate Forecasting, gives a comprehensive update on UK real estate lending from the opening up of the asset class following the financial crisis to an assessment of the likely impact from the UK referendum on EU membership.

Our industry-leading publications

Our global strategists combine valuable experience, thorough research and analysis to tackle major issues of the moment. To provide first-hand insight into the issues that are currently driving markets, we produce a global series of flagship publications.

Publication	
Weekly Economic Briefing	A regular analysis of major cyclical developments and structural themes in leading advanced and emerging economies.
Global Outlook	A monthly publication which includes a series of articles that examine investment trends and developments in each of the major asset classes, rotating between macro, country and sector or company-specific insights.
Global Horizons	An occasional report that captures the in-depth research of longer-term themes that help to form our House View. We also examine the major changes that are likely to influence financial markets in the coming years.

House View

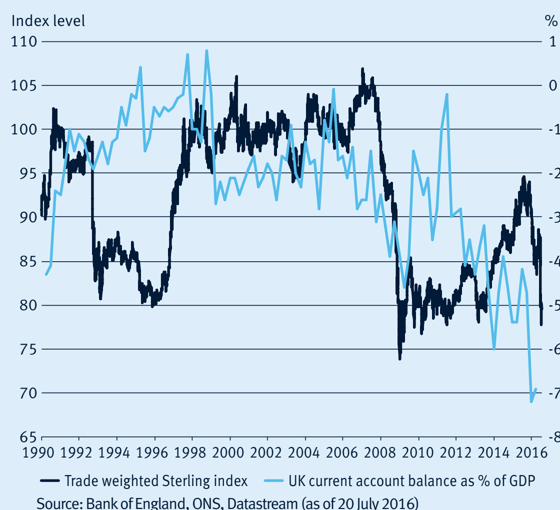
Keep calm and seek carry

Our investment framework constantly looks at cyclical economic and corporate drivers, but the growing importance of political uncertainty is a demonstration of some deep-seated structural issues facing societies and markets.

Andrew Milligan
Head of Global Strategy

Craig Hoyda
Multi-Asset Investing
Quantitative Analyst

Chart 1
Crunching the current account



Source: Bank of England, ONS, Datastream (as of 20 July 2016)

Winds of change

The Global Investment Group (GIG) held its quarterly meeting in early July, an apt time to assess the future direction of the global economy given the vote in the UK to leave the EU. The GIG was reassured that the stability of the global financial system was not in jeopardy, thanks to a variety of measures put into place by regulators in recent years, although it noted that the vote was a further headwind to globalisation. For much of the time after the 2008-09 recession, investors have found it best when making investment decisions to focus on cyclical drivers in general, and central bank policy decisions in particular. In the past 18 months or so, the importance of structural drivers has increasingly been recognised; the House View has emphasised that investors are operating in a world of low numbers, which strengthens the case for sustainable yield as an investment approach. More recently, testing the sustainability of that yield is important in an environment where corporate earnings have come under pressure. Politics are beginning to affect financial markets even more, and that was the case even before the EU referendum. We are now in an environment of radical uncertainty, so there are multiple potential outcomes to political discussions and treaty negotiations. All this means fiscal policy and structural reforms are becoming more important to determine whether countries can escape the low inflation world.

Politics in the driving seat

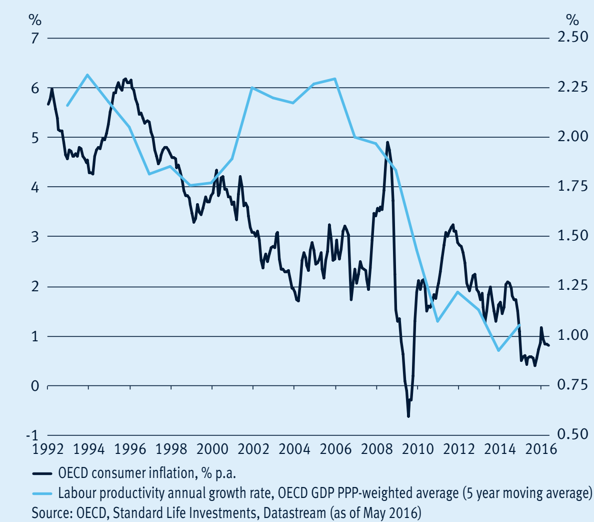
Recently, the EU referendum has been at the epicentre of many investors' attention. The market reaction is best exemplified by the initial plunge in the sterling exchange rate, showing the largest daily fall (around 8%) since the collapse of the Bretton Woods International Monetary System in 1971. It is important to remember, though, that the vote was not the only event of political importance this year: Spain is still negotiating to form a new government, while the result of the Australian election gives the government less room for manoeuvre. Over the coming year, a major risk is more political uncertainty: Italy is holding a referendum on constitutional reform that could potentially see the government fall; the US chooses between two candidates with very different aims and objectives for president; while the Dutch, French and German elections in 2017 will be extremely important in determining the future direction for the EU project. We see the result of the EU referendum as tying in with a trend in many countries towards euro scepticism, anti-establishment pushback and anti-globalisation, which collectively could potentially lead to significant changes in government policy.

Politics can affect markets in many ways. For example, we see sterling as the asset most exposed to the UK's exit, as its direction of travel will be highly sensitive to UK/EU negotiations. At the very least, sterling is an important adjustment mechanism, or shock absorber, as the UK economy begins to alter to the new reality. There is a low, but non-trivial, risk of a sterling crisis at some point should overseas investors cease to provide the necessary capital to meet the UK's sizeable current account deficit (see Chart 1). To accommodate this view on a medium-term time horizon, the GIG has taken a Light position in sterling versus the US dollar. Meanwhile, the dollar is preferable to the yen due to Bank of Japan policy moves to weaken the currency, and to the euro due to fears over Italian banks or other political obstacles affecting the single currency.

History is being made

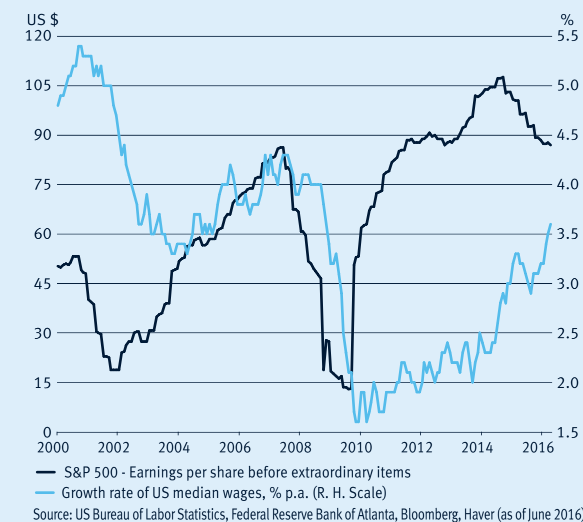
One of the most significant trends during 2016 has been the plunge in government bond yields. A variety of drivers explain this phenomenon: economic, demographic, regulatory and positioning. A series of structural factors have lowered innovation and productivity growth in many countries (see Chart 2), exemplified by the US Federal Reserve sharply lowering its estimate for trend rates of growth. Recent safe-haven flows due to worries about European politics have amplified an existing environment of historically weak economic growth and inflation for the global economy. In addition, even policymakers are asking more questions about the efficacy of monetary policy. The laws of unintended consequences are being seen, such as the adverse impact on markets of Japan's decision to adopt negative interest rates. In particular, as QE programmes drive more government bonds into negative territory (currently around one third of all sovereign debt globally), buying

Chart 2
World of lower numbers



Source: OECD, Standard Life Investments, Datastream (as of May 2016)

Chart 3
Pulling back profitability



Source: US Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, Bloomberg, Haver (as of June 2016)

pressures will grow on the remainder of the bond market with positive yields. Analysis of the global savings/investment imbalance is helpful in this respect. In effect, the demand/supply curve for fixed income markets is shifting rapidly, as a variety of investors reach for long duration assets.

We are confident that both monetary and fiscal policy will ease globally, ensuring bond yields will be lower for longer. Any hopes of the Federal Reserve hiking rates this year have been firmly moderated; the market-implied odds of a 25 basis point rise by the end of 2016 are evens at best. As Europe slows, the European Central Bank is likely to increase the size and scope of its asset purchase programme or abolish some of the limitations of its current approach as it runs out of eligible bonds to purchase. The Bank of England has eased policy to offset the uncertainty shock facing the UK economy, cutting the base rate and restarting its QE programme. An important trigger is whether and how monetary and fiscal policies are co-ordinated. This will depend on the expansionary nature of the decisions taken at November's Autumn Statement or mini-budget. The Bank of Japan looks again to be at the forefront of unorthodox policy moves. This raise questions: will its QQE policy support the large fiscal boost planned in the next supplementary budget? Will we even see some form of helicopter money, despite the legal obstacles?

We emphasise that while it is clear that central banks have done, and will do, their bit to support credit conditions, their firepower increasingly needs to be supported by fiscal policy and structural reforms in order to prevent their domestic economies from suffering undue shocks. Examples of structural reforms would include changes to education, skills, tax and labour market policy. Already the UK looks to be relaxing its budget deficit targets, while the European Commission is permitting several Eurozone members to ease their austerity agendas. In many countries, especially the US and UK, the demand for more spending on infrastructure projects is growing apace. While the carrot for policymakers is improved levels of economic output, the stick is the increased levels of support for populist parties. In all cases, the GIG emphasises that co-ordination would be helpful; if there is a lack of co-ordinated solutions, whether at the level of the G7, the Eurozone or the UK economy, then the final outcome will be suboptimal.

The House View

Sustainable yield remains a key investment theme, although the sustainability of that yield is becoming more significant. The House View continues to expect the hunt for yield by investors to drive asset class returns and, as a result, cash remains Very Light in the portfolios. As markets face a variety of political hurdles in coming months – notably the long, drawn-out process of UK/EU negotiations, requiring continued easy policy from central banks – it would seem inadvisable to be Light duration assets. Select government bond markets do offer return potential – we see safety in the UK gilt market and value in emerging market sovereign bonds.

Corporate profits continue to come under pressure (see Chart 3), as shown by the current S&P 500 Index earnings season, while the ability of companies to issue debt in order to fund share buybacks is lessening. We continue to position further up the capital structure by holding a large position in investment grade credit, and smaller positions in high yield debt as well as emerging market bonds. The yields on such asset classes remain relatively attractive, while these positions to an extent shield the portfolio from earnings or political volatility. We remain more concerned about the impact a continued slowdown in China will have on some markets; hence we are positioned Light in Developed Asia, mainly Australia and Hong Kong.

Commercial real estate continues to offer an attractive yield over other asset classes, more so outside the UK, if the illiquidity premium can be tolerated. European property should outperform other markets as the Eurozone economy is earlier in the business cycle, while the US market will benefit from cheaper funding costs as the Federal Reserve delays hiking rates. This exemplifies the GIG's view that investors should look on a global basis, and not focus on an individual market.

Spotlight

Risk and reward in private markets

A narrowing in liquidity differences between public and private markets, in conjunction with enhanced diversification potential, has increased attention on real assets. In a portfolio context, determining the impact of macroeconomic factors on asset cashflows allows us to quantify the risks.

Frances Hudson
Global Thematic Strategist

Nalaka De Silva
Private Markets Investment Specialist

Real assets in public and private markets

The quest for sustainable yield, better analytical tools and increasing accessibility via both public and private markets underpin rising allocations to real assets. These encompass a variety of markets, such as direct investment in infrastructure, real estate, private equity and private debt. Private markets, excluding hedge funds, with an estimated value of $4.1 trillion in September 2015, represent around 7% of total managed assets (Bank of America Merrill Lynch).

When we looked at real assets a couple of years ago, the potential was already clear in terms of both returns and enhanced diversification. However, we acknowledged that they did not represent a universal solution. We identified leverage, transparency and liquidity as recurring concerns and recognised that lumpy returns, sizeable shifts in asset valuation and protracted timeframes for entering and exiting positions make for frictional investing. We foresaw a situation where, as more liquid ways of investing were developed, public markets for real assets could become a crowded trade and returns there would diminish. The huge variations between public and private markets, and the lack of fungibility between them, means that returns in the less liquid private markets could be more sustainable. This article looks at what has changed since then and goes on to consider the challenges of including more private assets in portfolios, particularly when it comes to measuring risk.

Illiquidity and negative yields

As far as liquidity is concerned, there has been some convergence between public and private markets. New structures and tools for investing in real assets are being introduced but at the same time more of the public markets for conventional assets are becoming markedly less liquid. There is speculation that future versions of QE could include bonds backed by illiquid assets, such as commercial property or infrastructure, further blurring the lines between public and private, liquid and illiquid.

Two years ago, hedging against inflation seemed a remote concern, and for large parts of the world that remains the case. Today central bank policies – ultra-low/negative policy rates compounded by quantitative easing – have seen the global tally of government and corporate securities with negative yields approaching $10 trillion. Highly rated German bunds, for example, are negative as far out as ten years and yield only around 0.4% at 30 years. Investors have therefore been encouraged to seek bond-like returns elsewhere and are willing to extend duration and entertain alternative sources of risk premia in order to secure yield. In this light, the returns available on real estate and infrastructure appear munificent, if the timescales and illiquidity are acceptable.

The risks inherent in illiquid markets under current regulatory regimes were amply illustrated in the volatile aftermath of the UK referendum on EU membership. It was a useful reminder that the returns generated in private markets go hand in hand with variable levels of liquidity and increased difficulty in moving in and out of the asset class when markets are stressed and valuations uncertain. Long-term investors who are able to be patient, i.e. not constrained by regulation or prone to panic, are better placed in this regard. In contrast, the liquid instruments suffered greater volatility and overshooting; the FTSE REITs index for listed real estate experienced an initial drawdown of 22% but a month on was only 8% lower than the pre-vote level.

Diversification

The diversification case for real assets is broadly intact. Chart 1 shows that the private markets for real assets are less correlated, both to mainstream assets and to each other, and hence are better diversifiers than those that are exchange traded. To a certain extent, this may be another consequence of illiquidity and infrequent trading – the ensuing mismatch in cashflows reduces correlations. Volatility also appears favourable, but infrequent data points will tend to smooth the time series. Commodities are subject to speculative trading via the liquid and active derivatives markets, while REITs and listed infrastructure stocks trade within equity markets which increases correlations. In a portfolio context, using standard mean-variance analysis, including an assortment of private assets offers prospective improvements in risk adjusted returns. However, it is not clear that the framework for measuring risk in public markets is the appropriate one for portfolios comprising a combination of public plus a significant proportion of private market assets. The main criticism is that returns in private assets are more vulnerable to low probability, high impact tail risks and are therefore unlikely to be normally distributed.

A low return and increasingly volatile investment environment has seen investors turn to less liquid or illiquid investments in order to increase return, ameliorate loss severity and reduce volatility in portfolios. Recently, there have been increased allocations to bond-like equity investments such as infrastructure equity and core real estate as credit alternatives. There is also increased investment into private equity and private equity real estate strategies to seek higher returns, for example as pension schemes' funding gaps and liability matching gaps continue to exacerbate.

The evolution of risk management

As additional private assets are put into portfolios and they become less concentrated, as a group they will exhibit behaviours that are more market-driven than asset-specific. For example, owning multiple shopping centres across the UK will expose the portfolio to overall UK discretionary spending in addition to tenant default risk in particular retail parks. The tipping point in terms of the number of assets required to shift the risk basis in the wider portfolio to market or systematic risk will vary according to the underlying asset classes.

Applying traditional systematic risk or non-diversifiable risk measures to private portfolios is less practical due to limited historical data. It is difficult to form robust conclusions about how assets perform under different macroeconomic

conditions. Establishing the point at which private assets begin exhibiting market beta has always been tricky. Consequently, the alternative allocations have not had statistical risk measures applied consistently.

Bridging the gap between public and private markets risk is a significant challenge from two perspectives. Firstly, having a coherent view on market return outlook across debt and equity in each of the underlying assets classes often proves challenging. Secondly, finding a robust evaluation technique for stress testing individual projects compared with testing multiple projects with very idiosyncratic risk factors is a greater challenge.

Through the use of quantitative and qualitative techniques, we aim to develop our risk analytics across private markets. In order to understand the impact of macroeconomic scenarios on idiosyncratic assets, we can create a returns outlook House View along with two mapping exercises. The first map identifies the degree of economic correlation private assets have with each other. The second map assesses under which factors and degrees of magnitude the underlying asset stops performing. This takes the form of advanced cashflow modelling. Typically, most cashflow modelling emphasis is applied to specific elements on a two dimensional basis, for example, income versus interest rates or a combination of factors and how it affects a specific covenant. However, a number of factors are inter-related, for example sales are dependent on economic conditions, which link to value in the balance sheet, and ability to pay debt. In the scenario that GDP falls, sector costs increase and interest rates rise, and, depending on the orders of magnitude, the asset may not continue to perform. This requires a more quantitative approach to measure risk in the portfolio. The diagram illustrates a four-step process (A, B, C, D) for stressing individual asset performance under varying macroeconomic conditions on a consistent basis.

In A, we formulate a range of economic conditions from a central view to those that are extreme but plausible. In B, we use economic correlations and assign factors and degrees of magnitude for individual assets that may be affected. The individual cashflows are then modelled using a Monte Carlo approach – a computational method involving repeated random sampling – for each combination of potential economic drivers. Each combination of B will affect the physical cashflows of each asset class investments (C), giving us a dispersion in return for each of the underlying investments. Performing this analysis in a consistent manner provides output (D), which is an aggregated internal rate of return (IRR) and cashflow distribution. This approach should allow to us to map macro public market risk factors onto individual investment cash flows. If the same macro stress is applied to a public portfolio, we can provide a holistic view of risk in a client portfolio. These types of tools also offer the potential to provide robust internal ratings on debt assets and make objective asset allocation decisions. The goal is to assess risk and return in totality, whether it is a combination of public and private credit portfolios or measuring the diversification benefits of a portfolio of private assets.

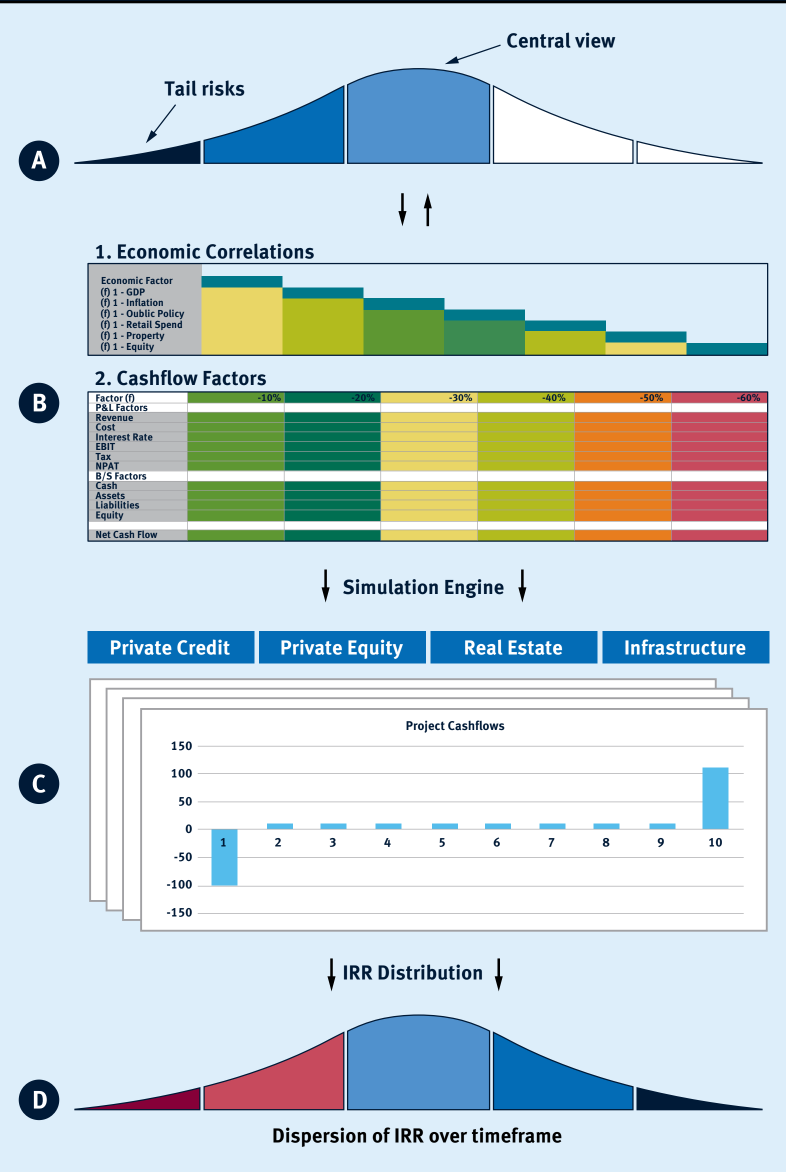
Chart 1
Updated correlations

Long Term Correlation Q1 2004-Q1 2016

	Equities	Commodities	10 year treasuries	Dow Jones Infrastructure	Global REITS	Inflation-Linked Index	Property	Timberland	Farmland	Global Inflation
Equities	1.00									
Commodities	0.48	1.00								
10 year Treasuries	-0.70	-0.25	1.00							
Dow Jones Infrastructure	0.90	0.54	-0.48	1.00						
Global REITS	0.91	0.41	-0.56	0.90	1.00					
Inflation-Linked Index	0.53	0.74	-0.02	0.67	0.53	1.00				
Property	0.53	0.42	-0.21	0.60	0.53	0.33	1.00			
Timberland	0.10	0.33	-0.13	0.13	0.04	0.09	0.48	1.00		
Farmland	0.04	0.26	-0.13	0.13	0.07	-0.06	0.46	0.75	1.00	
Global Inflation	0.38	0.75	0.01	0.46	0.27	0.71	0.49	0.26	0.14	1.00

Source: Bloomberg, Datastream, Standard Life Investments (as of Q1 2016)

Chart 2
Risk modelling incorporating macro



Infrastructure Equity

Transport infrastructure – avoiding turbulence

Transport infrastructure can provide stable returns and portfolio diversification. However, the potential varies significantly between assets and detailed research is required.

Dominic Helmsley
Managing Director, SL Capital Partners

Driving returns

Transportation assets, despite being a relatively small segment of the infrastructure market in terms of deals (roughly one fifth of the entire asset class in 2015), continue to be highly sought after by investors globally. In general, this segment can offer superior risk-adjusted returns while providing all of the key infrastructure investment characteristics, such as: stable long-term indexed cashflows, defensive nature of the risk profile due to essential asset status, wider portfolio diversification, and potential for value enhancement through active asset management. However, investors need to be aware of the large differentiation of assets within this segment of infrastructure. The types of assets range from fixed revenue project finance type assets, such as availability toll roads, to those operating in a highly competitive environment with a direct GDP exposure, such as stevedoring or aviation ground handling businesses. A simplified market mapping exercise (see Table 1) demonstrates the diversity within this segment, driven by specific underpinning asset characteristics; therefore, attracting investors from stable 'core' to 'value-add' or 'core +' strategies and even private equity players.

Table 1
Transportation assets: key characteristics

Low — Risk - Return Spectrum — High

Sub sector	Relative GDP Exposure	Core		Core +
		Illustrative characteristics		
Rail (ROSCO)		▸ Asset life lease ▸ Long term government lease underpinning	▸ Medium term leases ▸ 'Stickiness' to a specific franchise area	▸ Short term leases ▸ Easily interchangeable fleets, e.g. freight
Roads		▸ Availability based revenues ▸ Economic regulation	▸ Price regulation ▸ No viable alternative routes	▸ Relief road ▸ Viable off-peak alternatives
Airports		▸ Capital city ▸ Economic regulation ▸ Diverse airline / route base	▸ Large catchment area ▸ Regional monopoly ▸ Diverse airline / route base	▸ Secondary airport / local competition ▸ Small catchment area ▸ Limited airline / route base
Sea Ports		▸ Landlord owner ▸ Geographic advantage ▸ Economic regulation	▸ Terminal / warehouse operator ▸ Space constraints limiting competition	▸ Stevedore operations ▸ No space constraints ▸ Competitive environment

Source: UK Department for Transport, Infra News, Preqin, Sydney Airport, Eiffage, CAA, M6Toll, SL Capital Partners (as of July 2016)

Disparate experience

The effect of the global financial crisis of 2009 on various assets in this segment highlights this variance, even among assets that may have been classified as directly comparable. Asset resilience can be defined as the total decline in traffic from the highest point pre-crisis to the lowest point before the subsequent rebound. For example, on the basis of such a 'peak-to-trough' measure, select traffic performance, one of the primary performance indicators for transportation, was as follows.

- **Roads**: APRR (France) recorded a 1.2% decline in traffic, while M6Toll (UK) recorded a 22.2% decline;
- **Seaports**: Associated British Ports (UK) recorded an 18.9% decline in traffic, while Great Yarmouth Port (UK) recorded a 26.8% decline; and
- **Airports**: Edinburgh Airport (UK) recorded a 4.9% decline in traffic, while the overall airport market outside of London (UK) recorded a 16.4% decline.

Historic examples highlight that assets benefiting from robust investment appraisal, structuring and asset management can generate strong returns for investors. For instance, in 2011, Australia's MAp Airports sold their interests in regulated European airports in Brussels and Copenhagen, generating reported internal rates of return of 23.9% and 24.6% respectively. The contrary is also true; another investor, which acquired and disposed its interest in airports around the same time as MAp Airports, essentially handed over Glasgow Prestwick and Kent Manston Airports at nominal value as the equity had been squeezed out by unsustainable levels of debt versus poor operating performance of the assets. Similarly, a club of lenders is currently in the process of disposing of M6Toll after they 'took over the keys' to the asset in 2013. The asset suffered from an unsustainable level of leverage versus low traffic resilience. This spectrum of select experiences highlights the need for investors to possess strong sector and local knowledge to correctly appraise and structure the investments in such a highly differentiated asset class, as well as continue to manage the assets through the investment lifecycle.

Why transport?

In our view, the main attraction of transportation, even for those assets within the core segment, comes from its potential for superior risk-adjusted returns versus the wider infrastructure sector. It also offers portfolio diversification, given the different underlying drivers of cashflows and exposure to different regulatory regimes. For example, in 2016 we financed a fleet of 25 electric units, which form part of the essential London commuter network servicing railway lines from Moorgate Station in central London. We estimate that the fleet will serve over 1.3 billion passenger journeys over the expected lifetime of the asset. As a transportation infrastructure asset, this investment benefits from all of the key characteristics that you would expect from core regulated infrastructure: defensive nature due to essential service; long-term operating profile with no volume risks; and limited counterparty risk.

Despite the relatively smaller deal flow in transport versus utility and renewables, we continue to see sufficient deal flow in this space with attractive characteristics for our infrastructure platform. However, the wide spectrum of historical operational performances across the sector and the mixed bag of investment successes clearly indicate that deals in this segment require robust due diligence, structuring and asset management expertise.

Infrastructure debt

Infrastructure debt: essentiality and certainty

A true illiquidity premium is hard to find but can still augment infrastructure debt's qualities, which include a higher certainty of return, low risk and diversification.

Jeremy Allcock
Head of Infrastructure Debt

Necessary and predictable

In volatile markets, credit investors are increasingly willing to forego an element of return in exchange for a higher degree of long-term certainty. In the infrastructure space, credit investors conventionally sought a higher return, or illiquidity premium, for accepting a relatively low level of liquidity. The current trend, however, is towards a position where investors may pay a premium for securing an investment that provides strong credit characteristics, diversification and predictability over a long period, while also potentially matching liability profiles.

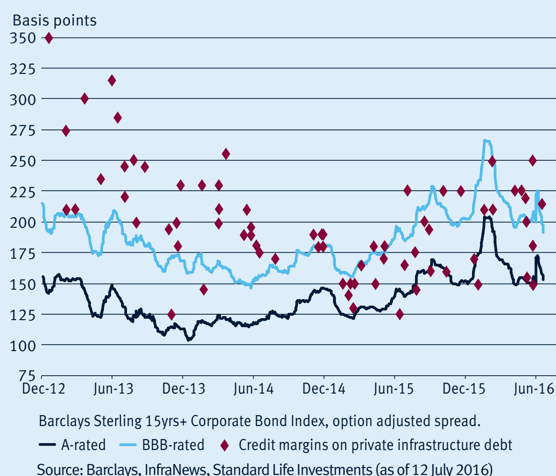
Infrastructure is essential for the smooth running of a country and for the well-being of its citizens. This essentiality creates certainty of use – infrastructure will, under most circumstances, always be required, either paid for by the government or by the user, and at a price that is reasonably assured into the future. Developed countries need to provide economic infrastructure in the form of an extensive transport network, wide broadband coverage and reliable energy provision. Social infrastructure, to deliver high standards of education, health and affordable housing facilities is also required.

Analysing the opportunity

Standard Life Investments manages infrastructure debt that has been used to finance the provision of essential infrastructure, where that infrastructure has been privately developed as opposed to being funded directly by the public sector or by a quasi-public sector entity like a university. The public sector may choose to procure the infrastructure privately for a variety of reasons. These may include one or more of: value for money, off-balance sheet accounting treatment, private sector rigour for the construction and/or operation of the infrastructure or introduction of an element of competition into the service offering. Unlike most corporate debt, investors in infrastructure typically benefit from senior-ranking security, i.e. the debt providers have the first call on cashflows produced by the infrastructure and access to the physical asset where available. In addition, bespoke infrastructure projects will generally be funded using project finance, where the infrastructure asset is financed from a ring-fenced vehicle, limiting the impact of external influences on the asset in question.

Investors can access this cashflow certainty by investing directly in an infrastructure asset, or via a dedicated infrastructure fund, or in a broader fund that invests in a range of so-called 'real assets'. In both, the relative certainty and low correlation to other assets/wider economic factors provides a stable complement to a more widely diversified range of investments. Long-term studies carried out by the rating agencies offer confirmation. For example, Moody's 2015 Default & Recovery Rates for Project Finance Bank Loans 1983-2013 recorded an average recovery rate of 80% of senior debt for defaulted loans compared to 60% for senior secured and 50% for senior unsecured loans.

Chart 1
Building in a premium



Source: Barclays, InfraNews, Standard Life Investments (as of 12 July 2016)

Standard Life Investments sources private market debt opportunities directly via relationships with financial or industrial sponsors of infrastructure. Infrastructure is capital intensive and can therefore require significant amounts of finance: for a debt investor this can make granularity harder to achieve without a material allocation, especially where the allocation is to a broader 'real assets' fund in which infrastructure only represents one component. Each investment also has to be intensively managed, with funds needing to maintain direct long-term relationships with borrowers and other stakeholders.

Chart 1 shows new issue credit margins on individual private infrastructure debt investments compared to benchmarks for long-dated (15+ years) BBB and single A rated corporates. The gap represents, at least in part, an illiquidity premium. From 2012 onwards the gap has clearly reduced. This reflects a number of market developments.

- Investors have been keen to lock into long-term investment returns in a perceived 'safe' asset and to achieve a higher return than has been available from low 'risk-free' yields.
- Illiquidity premiums can still be achieved, despite a relatively low supply related to tougher economic conditions.
- Investors' recognition of the low default risk and high recovery levels associated with senior-ranking infrastructure debt structured to solid investment grade levels.
- Regulators have reduced the capital requirement for project-financed infrastructure in Solvency 2 models.

Infrastructure debt is sought as an investment for its high certainty of return, low risk and diversification. To find investments that still deliver a true illiquidity premium now requires more searching and closer relationships with borrowers. Such investments can, however, still be found and are worth seeking out – particularly in an uncertain world.

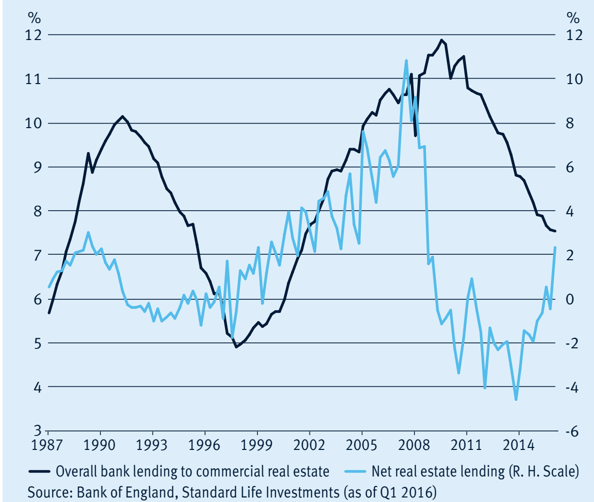
Real Estate

UK commercial real estate lending in a state of flux

Following several years of retrenchment after the financial crisis, UK commercial real estate lending has stabilised and is currently in a much better place. Will this state of affairs continue?

Simon Kinnie
Head of Real Estate Forecasting

Chart 1
Banks tearing down buildings exposure



Overall bank lending to commercial real estate — Net real estate lending (R. H. Scale)
Source: Bank of England, Standard Life Investments (as of Q1 2016)

A market in transition

UK commercial real estate lending has gone through a period of change and the make-up of different lending groups continues to morph. UK banks and building societies had dominated the market over the past few decades, accounting for close to 70% of lending by the start of the financial crisis (Source: De Montfort University Commercial Property Lending Market Report 2015). That event was a key inflection point for the commercial real estate debt market. Traditional lending banks were over-exposed to the asset class, as several years of strong returns from UK real estate coupled with elevated competitive lending pressures had outweighed normal lending prudence. Following a large number of loan defaults and lending covenant breaches, these typical lenders have steadily retrenched. Increased caution on the part of the banks coupled with more punitive regulation curtailed the amount and type of lending that they could carry out.

In turn, a range of new lenders has appeared, attracted by the potential for secure income and long leases that the underlying UK real estate market provides. From a negligible presence in 2011, insurance companies and other non-bank lenders now account for around 22% of the outstanding debt market. North American banks have also grown their lending books and command 6% of the market compared to 1.5% in 2011. The share attributed to UK banks and building societies has fallen to 45.5% and German and other international banks account for the remaining 26.5%.

In terms of liquidity, the amount of debt secured by UK commercial real estate has fallen from a peak of £250 billion (bn) to around £168bn. Broadly, as the market has recovered, new debt originations have increased steadily on a year-on-year basis from the low point in 2009. Originations totalled £53.7bn in 2015 compared to £45.2bn in 2014 and £15.1bn in 2009. Similarly, the amount of distressed debt written off has fallen steadily post the financial crisis. The amount of loans in breach of financial covenant also fell from £3.5bn in 2014 to £1.3bn in 2015.

Despite limited evidence of falls in capital value following the EU referendum, some discounted transactions involving motivated sellers suggest possible double-digit declines in the year ahead. This is in line with what is being priced in to the listed equities market. Against this backdrop, real estate lenders have naturally become more cautious and are demanding a higher risk premium for lending against the asset class. Senior lending margins have therefore increased from around 125 basis points to 200 basis points for core assets, while development lending, which had started to materialise, is likely to decrease sharply.

Can this state of affairs continue?

Prior to the EU referendum, the UK commercial real estate lending market had stabilised and lending was far more cautious than was witnessed in the last market downturn (see Chart 1). Lenders should therefore be in a better position to sustain some of the expected post-EU referendum decline in capital values. Relatively robust economic fundamentals will also mean that debt interest will continue to be paid, although some loans may technically breach loan-to-value covenants. Given wider market uncertainty, it is anticipated that the decline in capital values resulting from Brexit should be modest compared to the 2007/2009 period and the income will look attractive relative to a low level of income elsewhere. However, the downside risk for lenders could be more elevated if political uncertainty becomes more protracted and business and economic confidence falters more than is currently anticipated.

Our strategy within global real estate

Generally, we have a preference for prime and good secondary assets in a range of different countries. In the UK, given the uncertainty generated post referendum, we prefer high-quality, higher-yielding industrial-type assets and resilient, high-quality retail assets that are well located in areas with a lack of competition. On the Continent, expectations have not changed dramatically following the EU referendum; core European markets are forecast to produce attractive risk-adjusted returns supported by low development and accommodative monetary policy. Meanwhile, recovering markets continue to experience a rebound, generating higher absolute returns. Expectations for continued US economic expansion amid low supply growth will drive sturdy growth in cyclical office markets. 'Gateway' office markets continue to attract well-heeled foreign buyers and support pricing. Turning to Asia, relatively high property yields in Australia and new development opportunities given a shortage of prime office space in Tokyo are supporting double-digit returns in these office markets.

About Standard Life Investments

Standard Life Investments is one of the world's leading investment companies, offering global coverage of investment instruments and markets. We currently have global assets under management of approximately £269.0 billion – this equates to $359.6 billion, C$518.4 billion, A$483.0 billion and €323.6 billion (all figures as at 30 June 2016).

We are active fund managers, placing significant emphasis on research and teamwork. After in-depth analysis, our Global Investment Group (GIG) forms a view of where to allocate assets, based on the prevailing market drivers and on forecasts of future economic indicators. The GIG is made up of senior investment managers from the strategy and asset class teams and is responsible for providing the overall strategic focus to the investment process.

The House View delivers a consistent macroeconomic framework to our investment decisions. It generates the market and thematic opportunities for us to add value to our clients over the timescales they use to measure our success. It is formulated in such a way as to make timely investment decisions but to also allow all members of the investment teams to influence its conclusions.

Contact Details

For further information on Standard Life Investments visit www.standardlifeinvestments.com or contact us at one of the following offices.

Europe

Standard Life Investments
1 George Street
Edinburgh
United Kingdom
EH2 2LL

Telephone: +44 (0)131 225 2345

Standard Life Investments
90 St. Stephen's Green
Dublin 2
Ireland

Telephone: +353(0) 1 639 7000

Standard Life Investments
30 St Mary Axe
London
EC3A 8BF

Telephone: +44 (0)207 868 5700

Standard Life Investments
1 Rue de Berri
75008 Paris
France

Telephone: +33 158 05 22 70

Standard Life Investments
Taunusanlage 11
60329 Frankfurt am Main
Germany

Telephone: +49 (0) 69 665721764

Standard Life Investments Limited
Engelbrektsgatan 9-11
114 32 Stockholm
Sweden

Telephone: +46 (0) 707 507353

Standard Life Investments Limited
4th Floor 10 Via Mazzini
20123 Milan
Italy

Telephone: +39 0249 543 231

Standard Life Investments Limited
3rd Floor Rennweg 22
8001 Zurich
Switzerland

Telephone: +41 44 522 00 55

Standard Life Investments Limited
The Crescent
Parc Scientifique
Route de Lennick 451
1070 Anderlecht
Brussels
Belgium

Telephone: +32 470 991 668

Standard Life Investments Limited
Piet Mondriaanplein 13
3812 GZ Amersfoort
The Netherlands

Telephone: +31 6464 14172

North America

Standard Life Investments (USA) Ltd
One Beacon Street, 34th Floor
Boston
USA
MA 02108

Telephone: +1 617 720 7900

Standard Life Investments (USA) Ltd
299 Park Avenue, 6th Floor,
Room 655
New York, NY 10171
USA

Telephone: +1 212 739 0792

Standard Life Investments (USA) Ltd
11601 Wilshire Boulevard,
5th Floor, Room 505
Los Angeles
USA
CA 90025

Telephone: +1 310 235 1408

Standard Life Investments (USA) Ltd
First Canadian Place
100 King Street West
Suite 2525, PO Box 252
Toronto, Ontario, M5X 1C8
Canada

Telephone: +1 (647) 726 1424

Australia

Standard Life Investments Limited
Level 33 Chifley Tower
2 Chifley Square
Sydney NSW 2000
Australia

Telephone: +61 2 9947 1500

Asia

Standard Life Investments (Hong Kong) Ltd
30th Floor LHT Tower
31 Queen's Road Central
Hong Kong

Telephone: +852 3589 3188

Standard Life Investments Limited
1201-01 China Resource Building
8 Jianguomenbei Avenue
Beijing 100005
People's Republic of China

Telephone: +86 10 5811 1701

Standard Life Investments (Hong Kong) Ltd
Korea Representative Office
21/F Seoul Finance Center
136 Sejong-daero
Jung-gu
Seoul, 100-768
Korea

Telephone: +82 2 3782 4765

Standard Life Investments (Japan) Limited
18F Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku,
Tokyo 100-0004

Telephone: +81 3 45407930

Important Information

All information, opinions and estimates in this document are those of Standard Life Investments, and constitute our best judgement as of the date indicated and may be superseded by subsequent market events or other reasons.

This material is for informational purposes only and does not constitute an offer to sell, or solicitation of an offer to purchase any security, nor does it constitute investment advice or an endorsement with respect to any investment vehicle. Any offer of securities may be made only by means of a formal confidential private offering memorandum. This material serves to provide general information and is not meant to be legal or tax advice for any particular investor, which can only be provided by qualified tax and legal counsel.

This material is not to be reproduced in whole or in part without the prior written consent of Standard Life Investments.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by Standard Life*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, Standard Life* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Past performance is no guarantee of future results. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

*Standard Life means the relevant member of the Standard Life group, being Standard Life plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

Standard Life Investments Limited is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Standard Life Investments Limited is authorised and regulated in the UK by the Financial Conduct Authority.

Standard Life Investments (Hong Kong) Limited is licensed with and regulated by the Securities and Futures Commission in Hong Kong and is a wholly-owned subsidiary of Standard Life Investments Limited.

Standard Life Investments Limited (ABN 36 142 665 227) is incorporated in Scotland (No. SC123321) and is exempt from the requirement to hold an Australian financial services licence under paragraph 911A(2)(l) of the Corporations Act 2001 (Cth) (the 'Act') in respect of the provision of financial services as defined in Schedule A of the relief instrument no.10/0264 dated 9 April 2010 issued to Standard Life Investments Limited by the Australian Securities and Investments Commission. These financial services are provided only to wholesale clients as defined in subsection 761G(7) of the Act. Standard Life Investments Limited is authorised and regulated in the United Kingdom by the Financial Conduct Authority under the laws of the United Kingdom, which differ from Australian laws.

Standard Life Investments Limited, a company registered in Ireland (904256) 90 St Stephen's Green Dublin 2 and is authorised and regulated in the UK by the Financial Conduct Authority.

Standard Life Investments (USA) Limited is registered as an Exempt Market Dealer with the Ontario Securities Commission and as an Investment Adviser with the US Securities and Exchange Commission. Standard Life Investments (Corporate Funds) Limited is registered as an Investment Adviser with the US Securities and Exchange Commission.

Calls may be monitored and/or recorded to protect both you and us and help with our training.

www.standardlifeinvestments.com © 2016 Standard Life, images reproduced under licence

INVBGEN_16_1516_GS_OUTLOOK_AUG_TCM 0816