Interest rate turnaround and inflation

Alternative Investments remain robust - despite competition from rising bond yields

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Executive summary

Representative data from the BAI Investor Survey and BAI Member Survey shows **that about 80% of LPs and GPs expect alternative investments (AI) will not lose importance in strategic asset allocations (SAA)** due to the interest rate turnaround and inflation. However, data shows that the expected **impact depends on the investor type. While more investors with higher amounts of Assets under Management (AuM) expect shifts** in the SAA **towards traditional assets,** there are relatively **more "smaller investors"** who see **increasing importance for AI** in the SAA due to the situation.
Also, while **foundations, church & charitable investors, and pension schemes (German Versorgungswerke)** expect **AI to increase** in importance in the SAA, the opposite is true for **insurance companies** (Solvency and AnlV).

We asked institutional investors about their position and collected their statements to obtain a broad picture of the topic with its different facets. Therefore, German LPs claim to be well prepared for higher interest-rate and an inflationary environment. Data and interviews show that the **success factors of AI** are seen **as robust.** Fundamental characteristics and premiums of AI remain present, regardless of the interest rate levels and inflation. Though valuations have to be adjusted, and shifts within AI and different asset classes can be expected.

However, the **rising interest rate defines new benchmarks for AI.** Therefore, **(Investment Grade-) bonds are once again a potential substitute for those alternative asset classes** and strategies with profiles of comparatively low risk and return. This must be seen against the background that investors state a high degree of diversification through AI must be ensured in any case. Also, interviews and data show **possible adjustments and shifts between AI and traditional assets concern not existing investments but building up additional allocation - where new funds, returns, and re-investments are allocated.** We point out that the degree to which shifts from AI to bonds play a role for investors depends on their **return targets - real or nominal**. In the case of nominal return objectives, some investors will be able to meet the minimum return obligations in the liquid bond market with investment-grade securities. However, for a real capital preservation objective, bonds are still less of a potential substitute for alternative asset classes.

Furthermore, interviews and data show that **the denominator effect** is a crucial factor for possible shifts in SAA, which can be responsible for disruptions in long-term plans towards more diversification, particularly with those investors who have a mature AI allocation already. **Overall, based on analysis and the interviews, it can be assumed that the denominator effect is likely only temporary and that no longer-term effects are expected for SAA.**

Introduction

AI experienced a sustained boom and increasing importance in institutional investors‘ portfolios in recent years, also driven by persistently low inflation and interest rates. However, due to the current severe inflation shock, central banks around the globe have raised interest rates to curb inflation, which affects assets through different channels. As a result, stocks and bond markets experienced a historic joint crash. Alternative investments are also impacted by higher levels of inflation as well as by higher levels of interest rates - directly and indirectly, through multiple channels.

This raises the following question:

How will the changing environment affect the performance of AI and their relative strategic attractiveness and role for institutional investors?

Hence, BAI initiated a dialogue with investors and asset managers to understand channels through which AI are impacted. As a result, this is the second publication on the topic.

To obtain a broad picture of its different facets, we surveyed a total of **165 German institutional investors and asset managers** as part of the BAI Investor Survey 2022 and the BAI Member Survey 2022. In addition, we conducted nine expert interviews with LPs and GPs and numerous additional informal discussions.

In our recent publication[*], we already discussed the expected impact of high inflation and the ECB‘s interest rate turnaround on strategic asset allocation (SAA), because of diversification aspects and anticipated time horizons of changes. We argued that AI could play an increasing role in diversification due to changes in the stock-bond correlation. We also pointed out that the expected time horizon of increased inflation and interest rate level is crucial. Furthermore, we stated that another channel through which longer-lasting higher inflation and interest rate could impact SAA is through uneven impact on the risk-adjusted performance of different asset classes, also within the spectrum of alternatives[**].

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* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Interest_rate_turnaround_and_inflation_2022__0509_.pdf

** Defined as: Liquid Alternatives, Hedge Funds, Commodities, Corporate Private Dept, Corporate Private Equity, Venture Capital, Real Estate Equity, Real Estate Debt, Infrastructure Equity, Infrastructure Debt, Other Real Assets, Specialities, cf. https://www.bvai.de/en/alternative-investments/alternative-investments-in-general

A Big Majority of LPs and GPs do not expect AI will decrease its importance in SAA

With the results of the BAI Investor Survey 2022, we see that AI, in total, are defying the current market turmoil. With an existing allocation of 23% and a forecastable increase to 26% in SAA, alternative assets continue to grow and are becoming strategically more important. Net inflows are also expected for nearly all AI asset classes at the aggregate level, as the allocations shown in the SAA are higher than the current allocations*. And as our data shows, this trend is also mostly robust to changes in the interest rate and inflation environment at the aggregate level of all AI asset classes, according to both investors and asset managers. Of a total of 165 institutional investors and asset managers surveyed in our Investor Survey and Member Survey, around 80% said they do not expect any shifts in SAA from AI to traditional asset classes (Figure 1). Notably, the percentage here among the 106 LPs is very similar to that among the GPs (81% versus 78% Figure 2). There are differences between LPs and GPs only in assessing whether AI in the SAA will increase relative importance or whether no significant influence is expected, whereby LPs tend to expect adjustments. We discussed the reasons for different GPs' and LPs' perspectives in the prior publication.

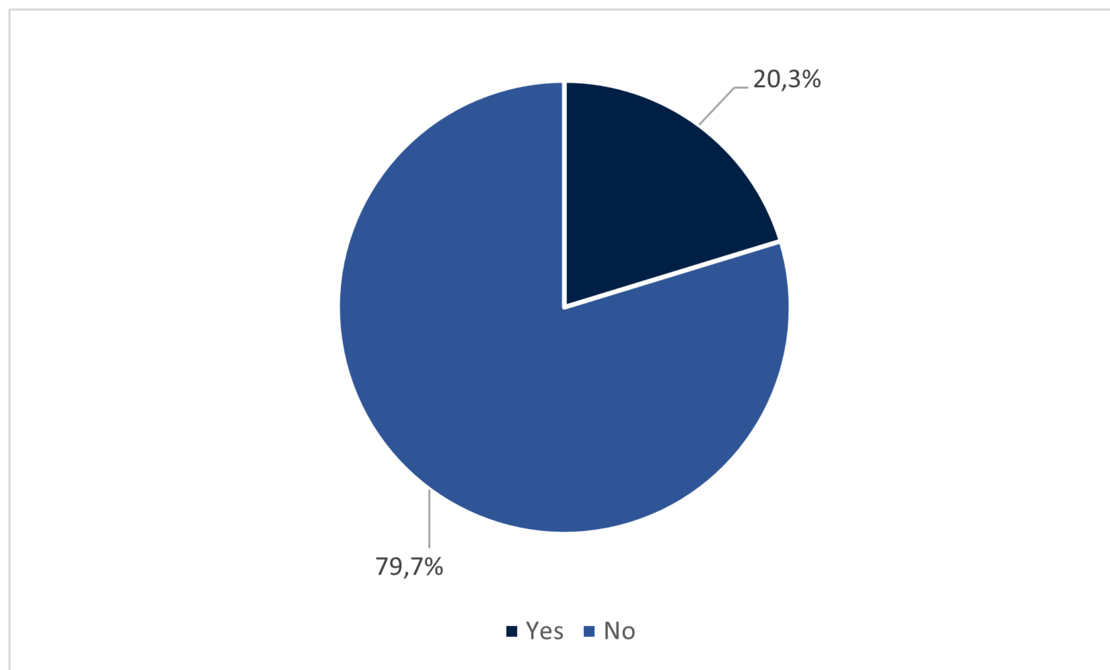

Figure 1: Do LPs and GPs expect that interest rate turnaround and inflation will lead to shifts toward traditional investments?

A more detailed look at the data shows different implications of interest rate turnaround and inflation regarding SAA for different investor types (Figure 2). For example, more than 30% of **foundations, church & charitable** investors expect **AI to increase** in importance in SAA, while less than 10% expect an increase in traditional assets. In the case of **pension schemes**, as many as 37% expect AI to increase, while 12% see the importance of traditional assets rising. **Insurance companies (Solvency and AnlV)** are at the other extreme, with 32% **expecting an increase in traditional assets** and just under 3% expecting an increase in AI in SAA.

Reasons for this, which we will discuss below, are the **different return targets and actuarial interest rates** applied by different investors and different current allocations. This determines to what extent rising interest rates and **traditional fixed income are in competition with AI.** In connection with this, “The denominator effect” has an impact on SAA.

* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/Investor_Survey_2022_final_red.pdf

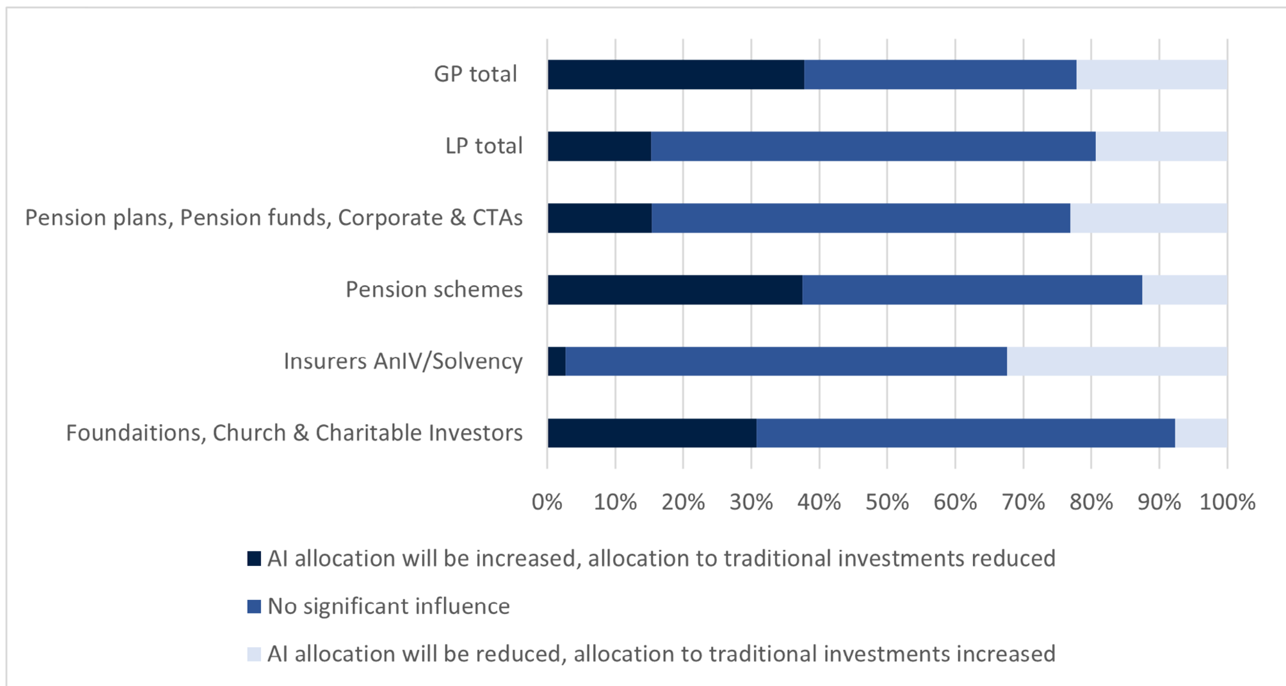

Figure 2: Expected shifts between AI and traditional investments due to interest rate turnaround and inflation by investor type.

Implications for SAA and AI: Perspectives from practice

To understand the impact of the changing market environment in more detail and gain insight into the practice, we spoke with institutional investors and asset managers on the topic.

Below are some statements on investors‘ challenges due to the interest rate turnaround and inflation in practice.

„The world is definitely becoming more complex. We now have a significantly higher risk situation, and that has to be taken into account in new investments. But the basic „story“ behind alternative investments is in no way jeopardised by this. The positive arguments for why we invest in alternative investments continue to exist in any case and are supported by long-term megatrends. For example, in the infrastructure sector, the megatrends of energy transition and digitalisation are covered, which will continue in the long term and may even be significantly accelerated by current geopolitical developments. The same applies to private equity, where targeted investments are made in long-term megatrends such as digitalisation and health, which will likewise persist, even if we should face a longer-term period of higher inflation and interest rate hikes.“

Armin Beerwart, Head of Alternative Investments, W&W Asset Management GmbH

„As a diversified investor, we face, among other things, valuation changes of illiquid assets and rising refinancing costs, as well as market dislocations in liquid markets. Tactical adjustments are also a challenge - for example, reallocations and new investments in higher-yielding fixed-income assets. At the same time, the existing diversification, which works well in the current market environment, must not be abandoned. Therefore, the allocation to alternative investments must be consistently pursued.“

Martin Koneberg, Head of Alternative Risk Premia, Bayerische Versorgungskammer

„If there is an interest rate to be observed on the market again, risk premiums for asset classes can be recalculated, and possibly revaluations by market participants can take place. However, a medium-term view of the „real return,“ i.e., after deducting the inflation rate, remains essential. The question of inflation persistence thus becomes crucial. Short-term inflation peaks bring certain asset volatility but do not pose a significant problem for long-term oriented investors.“

Rainer Maucher, Managing Director, Gemeinnützige Hertie-Stiftung

„The challenge is to find a balance between accounting, regulatory and economic requirements. This is expressed in the strategic asset allocation. This means that, on the one hand, the increased interest rate level and, on the other hand, the possible recession scenario (with an impact on the balance sheet) are taken into account. As a consequence, the direct portfolio tends to be strengthened, whereas the private market sub-asset classes, such as private debt, are slightly reduced. But here, there is the challenge of mobilizing investment funds for the targeted build-up of classic investments (in the case of discretionary mandates). Furthermore, there is the question of how to deal with possible loss realisations in the income statement. This could possibly deter one or the other from making shifts.“

Christian Chrobok, Head of Portfoliomanagement, BVV Versicherungsverein des Bankgewerbes a.G.

The voices of the investors interviewed during the expert interviews and those who spoke informally are basically in line with our survey results. Although the interviews revealed that **higher risks and uncertainties** are perceived overall, the **fundamental trend toward AI is seen as unbroken.** It was cited that the fundamental characteristic of AI remains present regardless of interest rate levels. Alternatives would therefore be used because **they can generate features or premiums that traditional assets cannot.** These AI categories could grow in importance, which are driven by current megatrends.
Furthermore, it was stated that a high degree of diversification through AI must be ensured in any case.

AI have a new benchmark – nominal versus real return targets

Investors differ regarding their underlying regulations and targets. A crucial aspect in understanding how the interest rate turnaround and inflation affect SAA is the actuarial interest rate investors use. During the last decade, the low-interest rates put pressure on institutional investors who had to fulfil **nominal** return targets. Therefore, they turned towards alternatives. However, due to the interest-rate turnaround and rising bond yields, traditional fixed income is gaining momentum again. Various investors and asset managers interviewed consequently stated that, under certain conditions, bonds regain relevance.

Andreas Kalusche, CEO of Prime Capital, sees only a limited impact on institutional investors' SAA through inflation because medium- and longer-term inflation outlooks have only changed marginally. On the other hand, due to the sharp increase in interest rates, there would suddenly be opportunities to meet the minimum return obligations in the liquid bond market with investment-grade securities for some investors. Therefore, **„AI has a new nominal benchmark to fight against."** However, the **difference between nominal and real impact** causes some confusion:

He observes that "market participants are currently having a mentally difficult time with the divergence between nominal and real price developments, similar to the way they did a few years ago with the then new concept of negative interest rates. Most do not know this difference from their personal experience and do not yet fully perceive it. Almost every time I ask someone after revealing his/her expectations for any prices or rates, whether nominal or real prices are meant, there is uncertainty at first, and it needs to be pondered. As a result, nominal share price developments are justified with real GDP developments; 2 or 3% interest rates are mentioned as a relief and as a reason to invest in government bonds again now, although real interest rates are still negative (and at the short end even more negative than before)."

And this is happening against the backdrop that many investors have tended to be under-allocated in liquid fixed income in recent years due to low interest rates, particularly in their direct holdings. In particular, mid-sized institutional investors have already done much for diversification in recent years, and now some may go back into liquids. Overall, Kalusche says, the rise in interest rates would lead to a need to **re-price alternative asset classes to some extent. This may lead many investors to reconsider their SAA.** Even those who did not have the topic on their radar are now thinking about whether they must make certain adjustments. However, possible shifts between AI and traditional assets do not concern a flight from AI but **rather where new funds, returns, and re-investments are allocated.**

Tina Jessop, Senior Economist, Partners Group, and Roman Smirnov, Senior Portfolio Manager, Partners Group, argue that the interest rate steps lead to a shift in the risk premium between fixed income and equity. Therefore, public fixed income, like government bonds, is becoming more attractive again. On the other hand, the interest rate turnaround, and the current inflation trend, which has led to volatility in financial markets, would have once again underlined the resilience of Alternative Investments, especially of private markets. Through the current crisis, Jessop and Smirnov **do not see a reversal of the trend but rather a further strengthening of the long-standing trend toward AI.** The decisive factor here, they argue, is that in a challenging market environment, an active manager can achieve excess returns, especially in Private Equity. In addition, they point out that the dispersion between best and mediocre managers is higher in private markets. Private asset classes can better mitigate inflation and interest rate effects than public classes. Thus, they see potential changes within the private markets and a continued discrepancy between returns achieved within private markets compared to the public market.

Looking at our data from the BAI Investor Survey 2022, we can see a convex connection between the share of investors who want to decrease the allocation in a certain asset class and the expected return of a certain asset class (Figure 3).
Therefore, a higher share of LPs tends to reduce the allocations in those asset classes with comparatively lower expected returns (Real Estate Debt, Real Estate Equity, Infrastructure Debt) - under a certain threshold of about 5% expected return. This could be explained by the fact that **traditional fixed income is emerging as a competitor** for those asset classes. However, this seems to be not the case for Infrastructure Equity and Corporate Private Equity. Also, for Corporate Private Debt, only a small share of investors wants to decrease the allocation, despite possible competition from traditional fixed income.

It must be noted that there are considerable differences within the asset classes regarding the expected return - depending on the strategy - which is not reflected in the aggregated survey data. This is the case also for Real Estate Debt and Corporate Private Debt, for instance. For example, credit specialties with comparatively higher risk and return profiles could gain significance. Also, Senior Private Debt performance remains comparatively robust; benchmark indicators indicate (Figure 4). Another explanation for the relative robustness of Corporate Private Debt provides Matthias Erb, Partner Private Debt at StepStone Group, who states: „StepStone Group has recently examined the impact of the current interest rate hikes, inflation, and negative growth impulses (recession) in a broad-based bottom-up analysis on a loan-by-loan basis and concluded that loss rates in senior Corporate Private Debt are predominantly influenced by economic growth and significantly less by interest rate and inflation aspects.“ Different implications of inflation, interest rate, and economic risks must be further examined.

Regarding the link between the share of investors who want to reduce the allocation and the average expected returns, the only exception is Venture Capital, with a very high expected return. This can be explained by the comparatively higher risk of the asset class with more insecure returns in the future. The more pronounced the risk profile, the greater the discounting required for future earnings, the greater the reduction in the present value of an asset class.
Detailed analysis of the implications of interest rate turnaround and inflation for different asset classes and survey data on the expected asset class, as well as differentiations within asset classes and based on strategies, will follow in an upcoming publication.

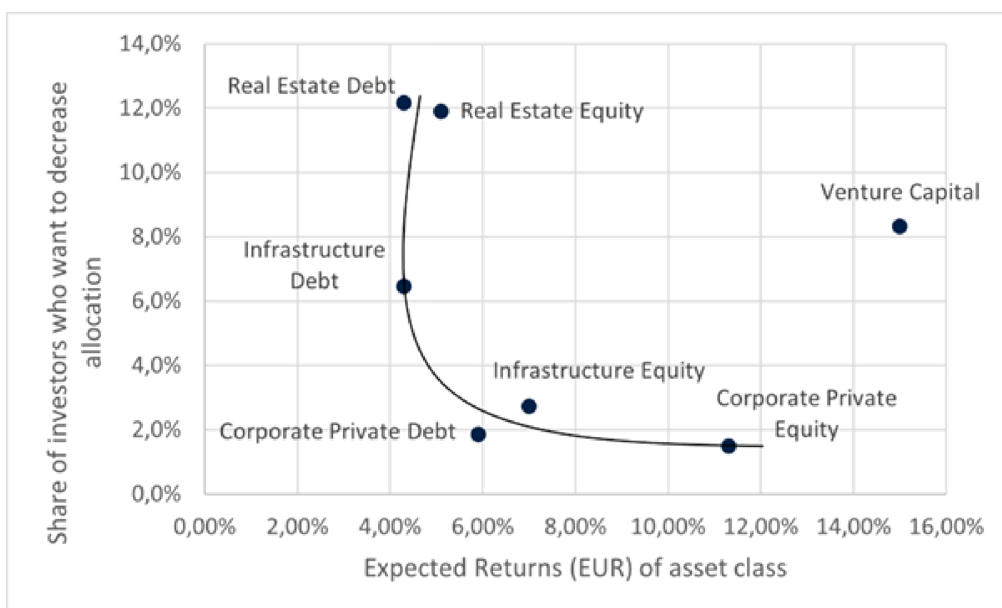

*Figure 3: Share of investors who want to decrease allocation and expected return of asset class.**

* Expected returns differ greatly within asset classes and depend strongly on the respective strategy. The data are only aggregated values of the BAI Investor Survey 2022.

However, looking at the data as a whole, the trend towards AI remains intact, as almost all alternative asset classes are seeing expected inflows - with allocations still below those reported in the SAA.* **It also appears from the interviews that if the interest rate turnaround and inflation play any role at all for SAA regarding AI, it is primarily about new capital inflows or shifts within asset classes.** Major shifts will only be seen when fixed income yields rise to the target range of infrastructure equity of 6-8%. A factor that may inhibit the additional allocation of new capital inflows into AI is discussed in the section about the denominator effect (see below.)

The extent to which possible substitution of AI through bonds impacts strategic asset allocation further differs depending on the type of investor and its return obligations. While bonds are becoming increasingly attractive for achieving nominally defined return targets, this is not the case for real value preservation or real return targets.

Some statements of investors to clarify the topic in the following

What are the challenges from the perspective of a pension scheme due to the interest rate turnaround and inflation?

„For a pension scheme, a changing interest rate environment and rising inflation can create tension with regard to the actuarial interest rate for pension beneficiaries. In addition, for strategic investment planning (asset liability management), various questions arise with regard to different input parameters and possible capital market scenarios that need to be examined in detail."

Martin Koneberg, Head of Alternative Risk Premia, Bayerische Versorgungskammer

What are the challenges from the perspective of a foundation due to the interest rate turnaround and inflation?

„The vast majority of foundations are committed to real capital preservation. Times of high inflation devalue a foundation's assets in real terms unless large parts are invested in real capital, which ensures at least a proportionate real value preservation. At the same time, grant recipients expect to be compensated for their increased costs, which can also lead to a higher outflow of funds."

Rainer Maucher, Managing Director Gemeinnützige Hertie-Stiftung

* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/Investor_Survey_2022_final_red.pdf

What are the challenges from the perspective of occupational pension provision due to the interest rate turnaround and inflation?

„To answer this question, the following three products must be distinguished.

On the one hand, the **traditionally defined contribution plan (BoLZ)**, the **BoLZ with lowered guarantees**, and the **purely defined contribution plan (rBZ).** The distinction is essential to address the issue of inflation or, better, positive/negative real interest rates.

In the case of traditional occupational pension provision, the focus is on the nominal interest rate. In other words, the current turnaround in interest rates is causing a slight reallocation from illiquid to liquid asset classes, such as government, quasi-government, and corporate bonds. Even in compliance with the requirements of the BaFin stress test, this allocation trend will be reinforced, provided that hidden net reserves were taken into account in the past.

The situation is somewhat different for the BoLZ with lowered guarantee and the rBZ. Here the focus is on the return opportunity, whereby in the first case, risks remain with the employer (subsidiary liability according to § 1 para. 1 sentence 3 BetAVG), and in the second case, the risks are passed on completely to the employee. Consequently, more equity or equity-like investments are made to ensure that inflation is also reflected in positive returns (positive real return).

Christian Chrobok, Head of Portfoliomanagement, BVV Versicherungsverein des Bankgewerbes a.G.

The denominator effect

Another aspect that has been increasingly brought into play by LPs and GPs when discussing reasons for potential shifts in SAA is the denominator effect. For example, one investor stated that the long-term plan towards more diversification and overall, the reasons for AI would have continued. If one sees disruption, it is because of the denominator effect. For perhaps two years, it could cause the need for rebalancing the portfolio.

This so-called denominator effect plays a role for those investors who no longer can increase AI allocations or even must reduce them: traditional investments (equities and bonds) lost massively in market value in the course of the developments this year, which in turn automatically increased the importance of illiquid assets in the allocation without active adjustments.

Liquid assets must be valued market-to-market immediately. While many liquid markets had massive losses in 2022, illiquid ones have not reacted as quickly (Figure 4). The beneficial stabilising effect of illiquid assets and the extremely high volatility of liquid markets leads to the denominator effect.

Actually, the characteristic that illiquid assets react more slowly than liquid ones is seen as an advantage of the illiquid ones in order to balance the portfolio. However, this beneficial characteristic of illiquid assets now had adverse effects. It caused many investors to fill their quotas for AI and over-allocate. **Those who are subject to investment quotas or regulations regarding capital requirements in AI can be inhibited - allowing less room for new capital commitments.**

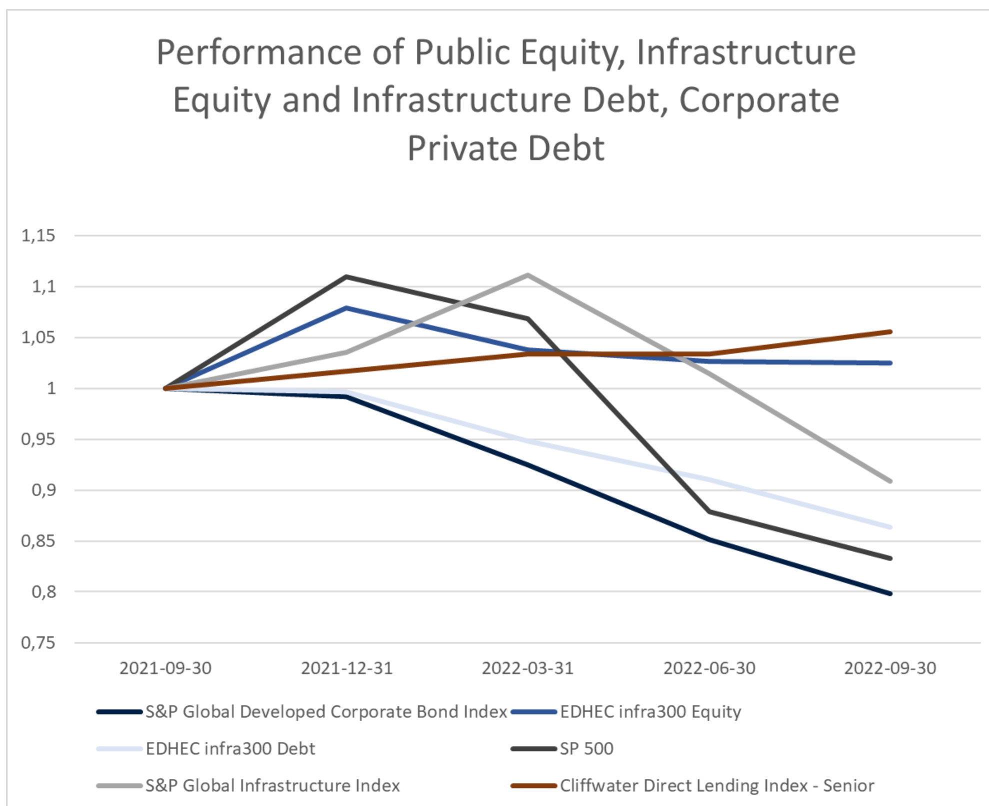

Figure 4: Performance of Public Equity, Infrastructure Equity, Infrastructure Debt, Listed Equity, and Corporate Bonds.

Alexander Damm and Oliver Schmidt of Metzler Asset Management see a clear increase in interest in liquid assets, which can be explained, among other things, by the fact that institutional clients are restricted by quotas on the illiquid side. As the attractiveness of bonds is now increasing again, they see a trend reversal towards bonds where illiquid assets were used as a substitute for bonds.

Andreas Kalusche, CEO of Prime Capital, also argued that the denominator effect clearly impacted institutional investors over the last 6 months, even if it was not as pronounced in Germany as in other countries, eg. the UK. However, he argues that the **denominator effect itself will most likely not be too problematic in the long run as it is more likely to be a temporary effect** and to settle down when liquid markets gain momentum again or illiquid markets catch up with some (down-ward) valuation adjustments. He assumes that in ceteris paribus, valuation declines of illiquid assets will most likely follow those of liquid assets to a certain extent in the near future.

However, illiquid assets would only come under pressure if there were sustained changes in the price parameters. A topic which had been already addressed in our recent publication.
Therefore, the question is how sustainable the steep rise in interest rates is. Inflation rates and interest rate yields could fall substantially, eg. in the event of an end to the Ukraine war.

What he further mentioned follows from the denominator effect and causes “new uncertainty” - the liquidity effect: investors were sometimes less stringent in their liquidity planning and always thought they would have enough liquidity in the event of capital calls for closed-ended fund allocations. However, with capital and liquid markets decreasing so quickly across the board over the last months, some investors needed to become much more sensitive on how to service capital calls without selling assets at a loss.

Regarding the expected influence of the denominator effect, Matthias Erb, Partner Private Debt at StepStone Group, argues, „a valuable indicator that the denominator effect is generally seen as a temporary factor concerning SAA is the fact that the sellers in the secondary private markets sector are currently mainly the GPs and not the LPs (investors).“

Overall, based on analysis and the interviews, we can assume that the denominator effect is likely to be only temporary and that no longer-term impacts are to be expected for SAA.

Looking at our data, **we can see investors with relatively small amounts of assets under management expect increases in AI allocations due to the interest rate turnaround and inflation, while "bigger investors" see rather increasing importance for traditional assets** (Figure 5). The fact that "bigger" investors expect decreases in AI allocation could be explained as a result of the opening of their portfolios towards AI is already very advanced. Thus, they are also **limited by the denominator effect in building up additional allocation.** The fact that investors who expect shifts in SAA towards traditional assets have a significantly higher current allocation to AI (Figure 6) also supports the argument. Since in the BAI investor survey 2022, our forecast for the AI quota for the average investor is 26% in the SAA, we can observe a possible trend-matching effect: Investors, on average, seem to converge towards this quota.

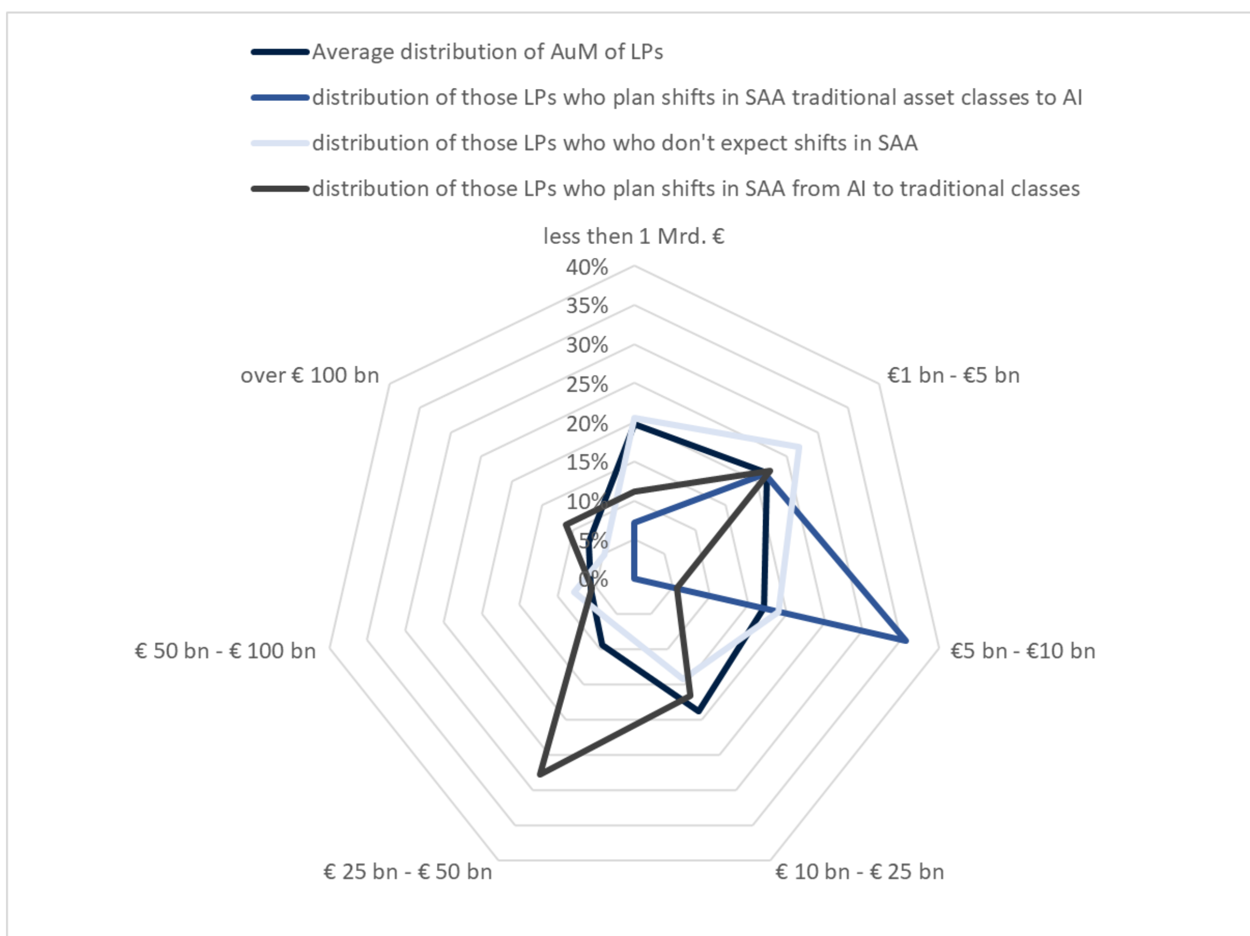

Figure 5: Different expected reactions in SAA on interest rate turnaround and inflation depending on AuM.

The effect that smaller investors tend to expect shifts toward AI is driven by foundations and church & charitable investors (Figure 2). As mentioned, more than 30% of foundations, church & charitable investors expect AI to increase in importance in SAA, while less than 10% expect an increase for traditional assets. Unlike other types of investors, such as insurance companies (Solvency 2, AnlV) or the occupational pension sector (IORP II), they are not subject to strict investment quotas or capital requirements. Therefore, they are technically not affected by the denominator effect and can continue to allocate to AI from a return and diversification perspective.

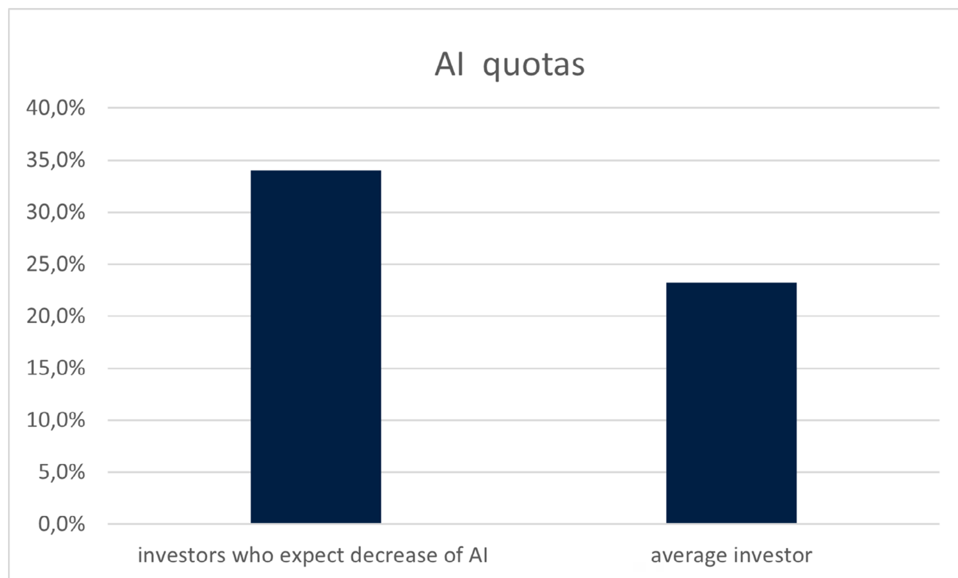

Figure 6: AI quotes of investors who expect shifts in SAA between AI and traditional assets versus the average.

Outlook

The first paper in the series discussed how the interest rate turnaround and inflation affect AI in terms of the need for diversification - due to a change in the stock-bond correlation. Also discussed was the expected duration of the shifts in the interest rate and inflation levels on AI. This paper examines the impact of the interest rate turnaround and inflation on alternative asset classes due to greater competition from bonds and the denominator effect. It is becoming clear that there are significant differences within the different AI asset classes, also regarding different strategies. In a subsequent paper, we will analyze how higher interest rates and inflation, as well as recession and stagflation risks, affect individual asset classes within the universe of alternatives. We will also address the geographical component of the issue, and possible different effects, e.g., in Europe and the U.S., will be discussed. For this purpose, we again present representative data from our BAI Investor and Member Survey and voices from investors and asset managers.

We would like to thank all those who supported this study, especially the investors and members who participated in the BAI Investor Survey 2022 and the BAI Member Survey 2022, and the participants of the expert interviews who are also quoted in the paper.

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