German Alternative Investor Landscape
Pension schemes (Versorgungswerke)

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Introduction

At the end of last year, the BAI Investor Survey 2021 was published and received wide attention. With this publication, we continue our sequence of studies about the German Alternative Investor Landscape with a detailed view of „Versorgungswerke," hereinafter referred to as pension schemes.

Present portfolio breakdowns of German pension schemes show that alternative investments have become firmly established in their portfolios. The exposure of pension schemes in alternative investments (AI) with an average of 36% is already encouragingly high concerning their overall portfolio. Therefore, pension schemes are more heavily invested than the average German investor, with an average allocation of 22.7%, as shown in the BAI Investor Survey 2021.

Regulation is one of the most critical frictions for pension schemes when investing in AI. The German Investment Ordinance ("Anlageverordnung") applies to pension schemes via the respective state law and sets out the investment framework. Quotas define the maximum possible proportion of investments. For investments in alternative assets, pension schemes must take the risk capital investment quota (35% „Risikokapitalanlagenquote") and the alternative asset quota (7.5%) into account. Real estate funds have a special status in this respect, as they are not counted on the risk capital investment quota but on the real estate quota (25%). However, depending on the investment, individual assets may be subject to the ABS quota (7.5%). All in all, an oversimplified presentation of the complex quotas from the BaFin Rundschreiben 11/2017.

However, pension funds must invest heavily in asset classes that still generate adequate returns. In many cases, they reach the limits of the regulatory quotas. Legislators have also recognized this. Therefore, pension schemes under North Rhine-Westphalian state supervision can now separately apply for an additional infrastructure quota of 5%, which does not fall under the risk capital investment quota but is subject to review by the state Ministry of Finance. The additional infrastructure quota does not only relieve usual quotas under the "Anlageverordnung" and gives pension schemes more scope to invest in AI. It also provides the opportunity to redirect funds towards sustainable infrastructure investments.

Infrastructure as a dynamically developing asset class has long since established itself as an anchor of stability in the portfolios of German institutional investors. According to the latest BAI Investor Survey, German pension schemes already allocate an average of 4.1% (1%) to infrastructure equity (debt) and intend to expand their exposure to 5.2% (1.9%) as part of their strategic asset allocation plans (figure 4).

Moreover, there are already signs that fundraising will reach new highs again this year. Therefore, it will come as no surprise if institutional investors adjust their strategic allocation upwards in the next BAI Investor Survey, as we have also observed in recent years.

Both product providers and investors stand ready and move forward with a responsibility to finance the transition of the economy and infrastructure. Now it is the task of politics to make good on this because the state will not be able to handle this overwhelming task alone. The infrastructure quota in North Rhine-Westphalia can only be the beginning. Otherwise, it would only be a drop in the bucket.

Structure and representation of the participating pension schemes

In this report, we take a closer look at allocation and are going to answer the following questions about how German pension schemes are invested in alternative asset classes:

1. Why do pension schemes invest in alternative asset classes?
2. Which alternative asset classes do pension schemes invest in?
3. Which alternative asset classes show increases or decreases in the number of invested pension schemes?
4. To what extent are pension schemes invested in alternatives, and how is the strategic asset allocation set?
5. What are the main challenges for pension schemes in various alternative asset classes?
6. How do pension schemes build exposure to alternatives?
7. What role does ESG play in pension schemes?

Pension schemes represent the third largest group in the BAI investor survey, with 16 out of the 104 investors participating. They ensure that the liberal, self-employed professions such as doctors, pharmacists, architects, notaries, lawyers, tax consultants and tax agents, veterinarians, auditors and certified accountants, dentists as well as engineers and psychotherapists are covered by compulsory old-age, disability, and survivors‘ pensions. They are a fundamental pillar of retirement provision for their members.

On average, the pension schemes surveyed have around EUR 8 billion in assets under management (AuM). However, the participating pension schemes‘ AuM are not evenly distributed - they range from under EUR one billion to over EUR 50 billion.

The “Arbeitsgemeinschaft Berufsständischer Versorgungseinrichtungen” (ABV) states end of 2019 that German pension schemes manage a combined amount of EUR 231 billion for over one million eligible members. Our survey covers around 55% of the total AuM of the German pension schemes, a representative sample of the entire pension scheme landscape.

At the beginning of the survey, we gather information from investors on how they assess their own experience in the field of alternative investments. The experience of the individual investors is highly heterogeneous, with a wide range from relatively inexperienced beginners to experts in the field of alternative investments, whereby German pension schemes have one advantage over many other investor groups: They have been operating in the market for a long time and tend to be among the most experienced investors (figure 1).

Experience plays a crucial role in building exposure in the private markets. By their very nature, experienced investors, possibly combined with large in-house investment teams, have a more diverse range of access to alternative investments such as direct or co-investments. We recommend that especially relatively inexperienced investors seek external expertise and advice. Our investor survey 2021 shows that experience is necessary even for entry-friendly products such as funds of funds.

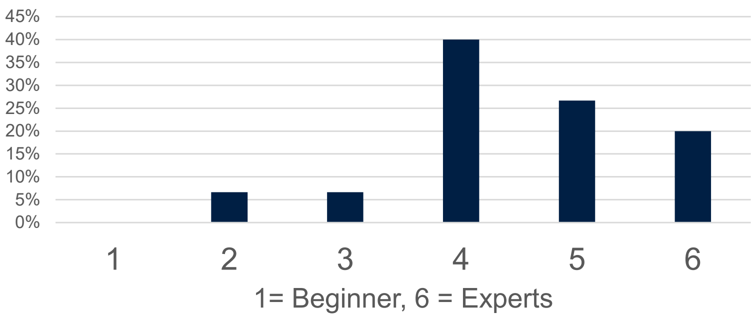


Figure 1: Most pension schemes have been active in the market for a long time.

1. Why do pension schemes invest in alternative asset classes?

We asked different investor groups and asset managers (GPs) about their motives for investments in alternative asset classes. AI are attractive for pension schemes and other types of institutional investors for various reasons. The primary motivation to engage in AI is portfolio diversification and the good risk-return ratio over the last decades by unlocking essential risk premiums such as illiquidity and complexity premiums (figure 2). Apart from that, the low interest rate environment certainly puts pressure on pension schemes. But, what stands out is that GPs overstate the importance and the attractiveness of AI as a substitute for regular bonds as an argument for investment in alternative asset classes for institutional investors. Therefore, we are confident that even in an increasingly likely scenario of significantly rising interest rates and bond yields, demand for AI will not abate.

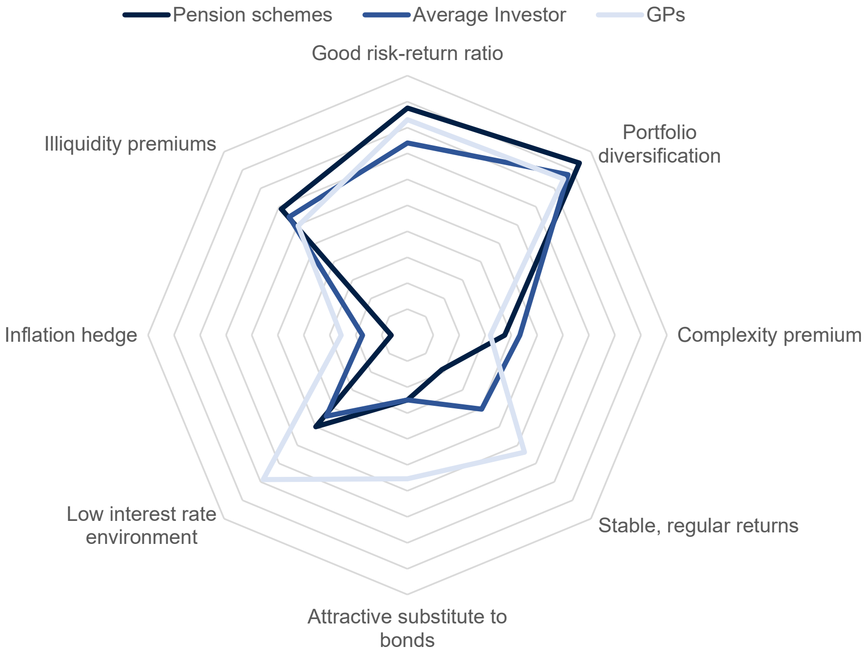


Figure 2: Key drivers for investing in alternative asset classes.

2. Which alternative asset classes do pension schemes invest in?

Compared to the average German institutional investor, pension schemes have the highest participation rates in almost every alternative asset class, with liquid alternatives as an exception (figure 3). Pension schemes are also frequently invested in asset classes that typically belong to the niches among alternative investments. These include, in particular, ILS (cat bonds and collateralized reinsurance), trade finance, aircraft, farmland, and timberland.

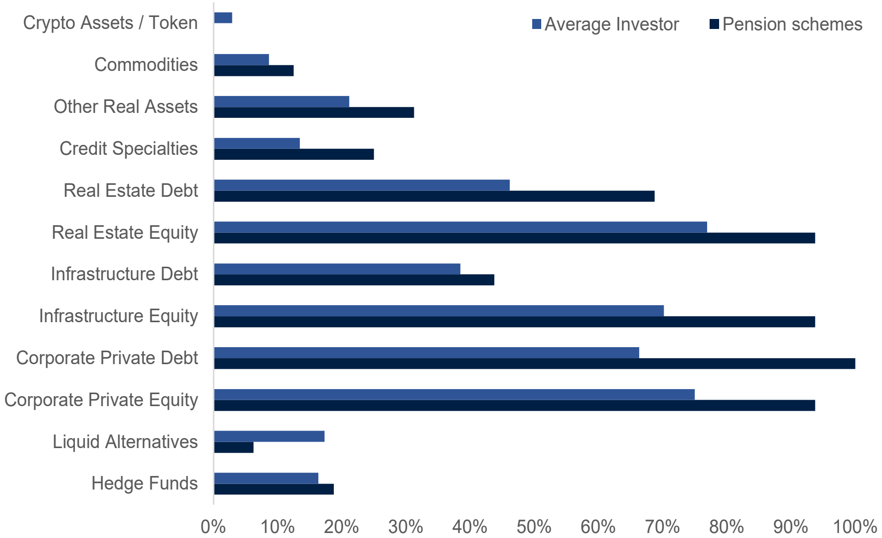


Figure 3: Percentage of investors invested in the respective asset class.

3. Which alternative asset classes show increases or decreases in the number of invested pension schemes?

In minimal numbers, pension schemes report having exited their hedge fund, liquid alternative, and commodity investments in recent years. However, it remains to be seen whether this trend will continue or turn around as we expect in phases of more significant uncertainty and volatility in the liquid markets and increased commodity prices recently. Moreover, since pension schemes are more broadly diversified across almost all private markets than any other investor group in Germany, the scope for entering new asset classes remains limited. Accordingly, pension schemes open their eyes to niches like credit specialties, infrastructure debt, and other real assets such as farmland or timber.

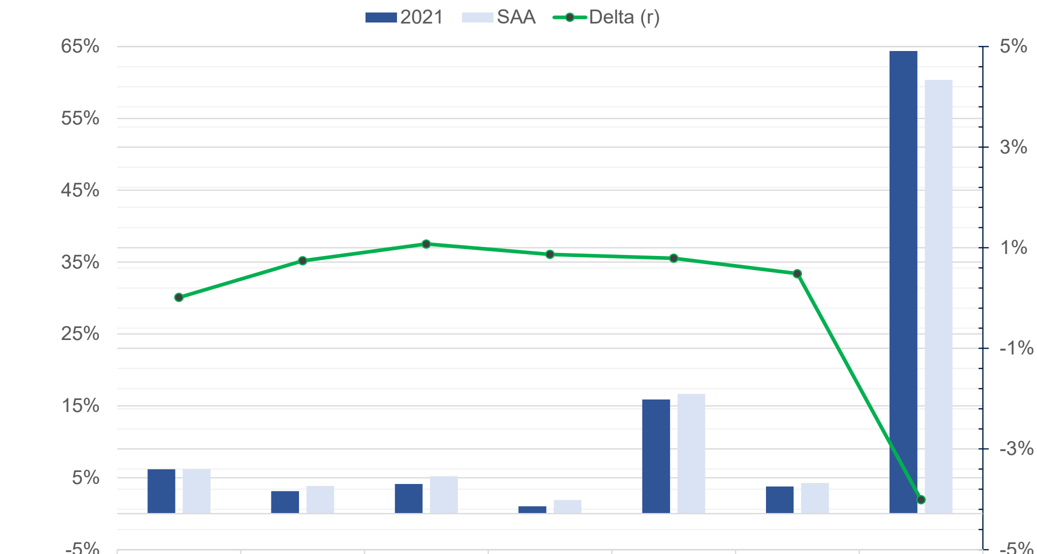
4. To what extent are pension schemes invested in alternatives, and how is the strategic asset allocation set?

Depending on the German federal state, the pension schemes are generally subject to the regulations on investment for pension funds and small insurance companies (Anlageverordnung). These specify limits for various asset classes, which may only be exceeded to a limited extent within the framework of a defined opening clause. At the same time, the accounting systems of the pension schemes require an annual return on the actuarial reserve, the so-called "Rechnungszins". In the current market environment, it is becoming increasingly challenging to generate adequate performance sustainably. Accordingly, the share of fixed-income securities has been continuously reduced in all pension schemes in recent years, and the weighting of illiquid asset classes has been significantly increased.

Current allocations show that alternative investments have become firmly established in pension portfolios. The average allocation of pension schemes in AI (36%) is already very high. Therefore, pension schemes are more heavily invested than the average German investor, with an average allocation of 23%.

Moreover, the outlook for AI in the portfolios of German pension schemes is positive, with a projected four percentage point increase up to 40% overall allocation in the upcoming years, as indicated by the investors surveyed in their strategic asset allocation plans (figure 4).

Currently, pension schemes in Germany are invested to the greatest extent in real estate, divided into 16% equity and 4% debt investments. The most significant increase in strategic importance is seen among pension schemes in infrastructure equity, with a projected relative increase in allocation of more than 25% or one percentage point from 4% to more than 5%. BAI has already reported regulatory relief for insurers under Solvency II, which provides more scope for investment in infrastructure. The foundations for a similar solution for pension schemes regulated under "Anlageverordnung" have already been laid, starting in North Rhine-Westphalia. In principle, pension schemes are subject to different regulations under state law, some of which are rigidly based on federal requirements. In contrast, others deviate from them, always intending to achieve sufficient diversification. Pension schemes under North Rhine-Westphalian state supervision can now separately apply for an additional infrastructure quota of 5%, which does not fall under the risk capital investment quota but is subject to review by the state Ministry of Finance. The audit is carried out concerning increased reporting requirements, integration of a sustainability strategy, restrictions on free assets, and stricter risk management. This does not only relieve other quotas under the “Anlageverordnung” and gives pension schemes more scope to invest in AI. It also provides the opportunity to redirect funds towards sustainable infrastructure investments.



	Corporate Private Equity	Corporate Private Debt	Infrastructure Equity	Infrastructure Debt	Real Estate Equity	Real Estate Debt	Traditional (Stocks, Bonds)
2021	6%	3%	4%	1%	16%	4%	64%
SAA	6%	4%	5%	2%	17%	4%	60%
Delta (r)	0%	1%	1%	1%	1%	0%	-4%

Figure 4: German pension schemes' average current vs. planned strategic asset allocation.

5. What are the main challenges for pension schemes in various alternative asset classes?

Dry powder is cited as the most significant challenge for the essential alternative asset classes – corporate private equity, corporate private debt, infrastructure equity, and infrastructure debt in the coming years (figure 5). While, in general, the challenges of pension schemes are very similar to those of the average investor, they see a little question mark behind the performance of their real estate investments, which rising asset valuations and interest rates can possibly explain. An international comparison of different investor groups can also explain the statements made by the German pension schemes. International investors surveyed by Preqin in their “Investor Outlook H1 2022” state that their real estate investments had exceeded expectations in the past. Still, they are tempering their expectations for the future, driven by a shift in perception of the market cycle in the belief that the market has already peaked.

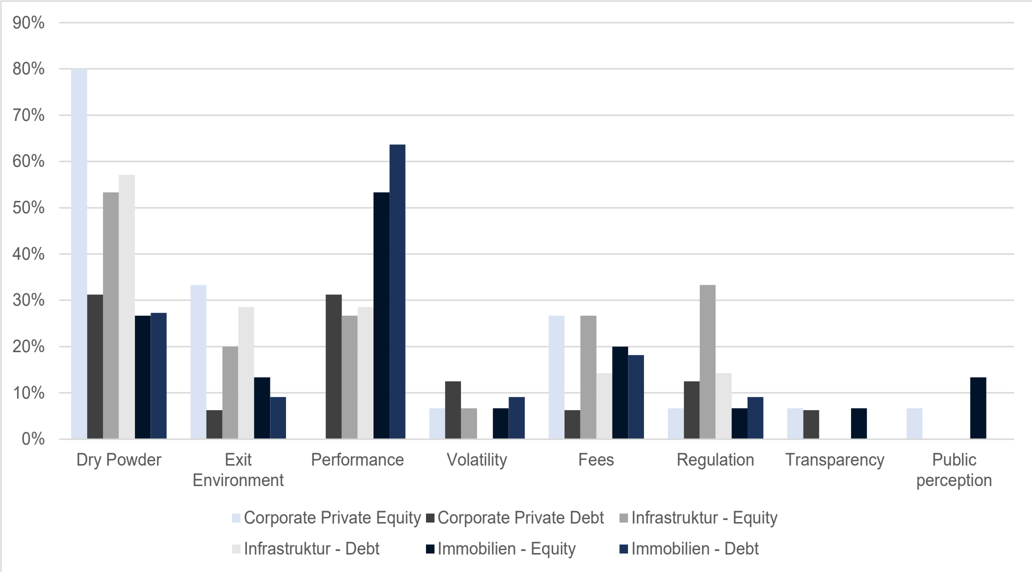


Figure 5: The significant challenges in the respective asset classes from the perspective of pension schemes.

6. How do pension schemes build exposure to alternatives?

Due to their early commitment many years ago, particularly in private equity, most pension schemes have a high level of experience in alternative investments (figure 1), enabling them to use diverse access channels such as co-investments (figure 6). The most frequently used access channels differ from asset class to asset class. It should be noted that most pension schemes invest in various asset classes via more than one access channel.

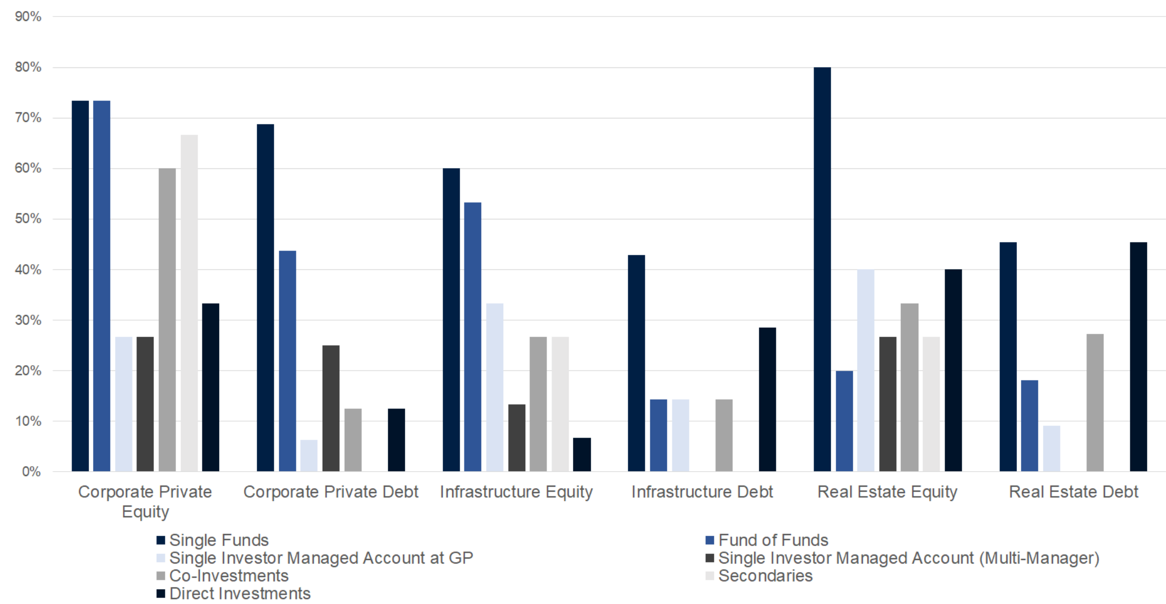


Figure 6: Access channels to private markets used by pension schemes.

Data shows that fund of funds are considered the investment vehicle best suited for beginners in AI, while direct investments require the most experience among investors. The size of the investment teams (full-time equivalents) also plays a decisive role in choosing the access route. For example, a comparison with the insurance companies questioned in the survey is revealing. On average, insurance companies have higher AuM and larger investment teams and can handle more complex and resource-intensive direct investments in infrastructure or real estate projects.

7. What role does ESG play in pension schemes?

ESG considerations play an increasing role in pension schemes' investment strategy and risk management. In the BAI investor survey 2021, 63% of the pension schemes answered that they have a well-defined ESG strategy with concrete objectives. The focus for German pension schemes is on the "G" of ESG – governance risks such as corruption or tax issues – whereas at the same time, „E" and „S", environmental and social risks, are also of importance. Due to their status as often mandatory pension providers, pension schemes do not need to misuse ESG considerations and sustainability strategies for marketing purposes only. Since they are not directly exposed to media pressure in general, they can deal with the topic of sustainability in an objective and differentiated manner. At this point, there is a clear difference from other investor groups surveyed. For pension schemes, therefore, the primary concern is to meet the expectations of their members, avoid reputational risks, and mitigate investment risks through up-to-date risk management.

References:
1) BAI Investor Survey 2021
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3) BaFin Rundschreiben 11/2017
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