Listed Investment Companies

A healthy future

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"This report assesses recent growth trends in the investment company sector and predicts growth trends for the coming three years. We show that growth is likely to continue unabated in the coming years with alternative investments outpacing equity investment companies. While there is considerable uncertainty about future outcomes, our scenario analysis shows that even in our pessimistic case, the investment company sector is likely to grow, while growth is likely to accelerate from recent levels in the more benign scenarios over the next three years."

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Introduction

On 13 September 2018 we published our report titled "In Alternatives We Trust" where we focused on listed alternative investment companies and their rise to become the dominant driver of new issuance and asset growth in the investment company sector. This report provides the first annual update of our projections for the coming three years. We review the year 2018 and provide an update of growth rates in assets under management and issuance over the last couple of years.

In the second part of this report we update our projections for asset growth for the next three years until 2022. Given the uncertainty around Brexit with its potentially big impact on economic growth and interest rates in the UK (and with it the demand for investment products), it is even more important than usual to analyse different scenarios for the future rather than rely on a point forecast.

Finally, the third part of this report will focus on an emerging trend within the investment company sector: the rise of ESG investments. Investments that take environmental, social and governance criteria (ESG) explicitly into account in the investment process have become increasingly popular in recent years and in the European Union, and regulators are working on the legal requirements for institutional investors to include ESG factors in their investment processes. The third part of our report will show that ESG-compatible investment companies have grown at a faster rate than the overall sector, but there is still a lot of headway to make in the future. In our view, ESG investments are here to stay and should provide ample growth opportunities for the sector.

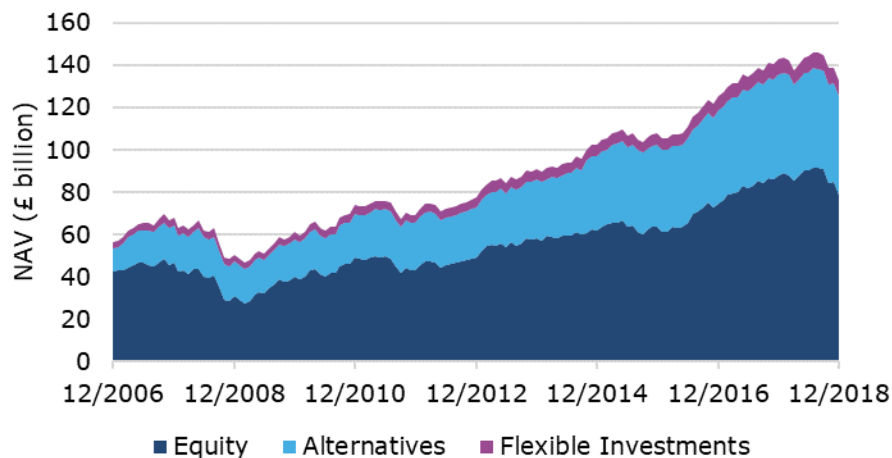
2018: A good year with a speed bump

2018 has been a good year for listed investment companies overall with a total of 19 new companies launched throughout the year. By far the biggest new issue was Smithson's £823m IPO in October (the largest investment company IPO ever) with Tritax Eurobox £300m IPO taking the crown in the alternative investment space.[1] As always, a few funds had trouble, which should not surprise anyone in what was a challenging year, so that the net number of investment companies in our database increased by 13 in 2018. Secondary fundraising was also robust with the AIC reporting a total of £4.8bn, 68% of which were raised by alternative investment companies with BioPharma Credit taking the individual crown at £349m.

No surprise then that the combined NAV of the companies in our database (which comprises 547 companies listed in London or Amsterdam and ignores VCTs and smaller funds) peaked in August 2018 at £146bn before declining 9% towards the end of the year (Fig. 1). This decline in net asset value was driven by equity investment companies (-13.9%) while alternative investment companies held rather stable (-1.1%). At the end of 2018, 79% of the assets we track were invested in equity investment companies, but that share is shrinking with alternative investment companies accounting for more than 65% of new issuance in every year since the Global Financial Crisis (GFC).

[1] For details about the classification we use in this report, see Appendix 1.

Fig 1: Evolution of listed investment company market in the UK

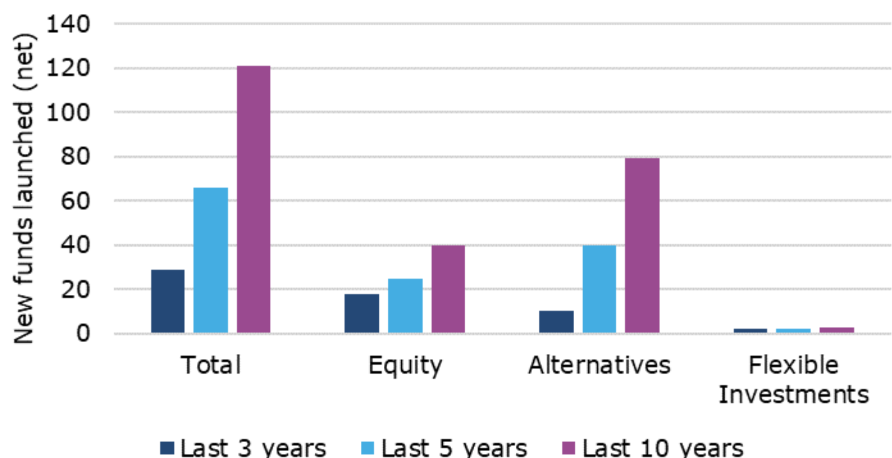


Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018.

Chugging along nicely

Zooming out from 2018 to review the last ten years since the GFC, we can say that growth in the investment company sector remains steady. The net number of new companies over the last decade has been c. 12 to 13 per year so that 2018 was pretty much in line with recent experience. This is an encouraging sign given that in 2016 and 2017 the net increase in the number of companies in our database was somewhat below that average. As Fig. 2 shows, most new investment companies were launched in the alternatives space, with roughly three out of five new companies specialising in alternative investments rather than equities during the last decade.

Fig 2: Growth in number of investment companies



Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018.

Digging deeper than just the pure number of funds, we show the growth of different subsectors over the last three years in Fig. 3. The dominant sectors over the last three years have clearly been listed infrastructure and renewable energy investments, outpacing all other subsectors in terms of issuance and NAV growth. Over the last three years the net asset value of infrastructure and renewables investments has grown by a whopping 58%. This number combines NAV growth through new issuance

and the actual performance of existing assets. Given that most infrastructure and renewable energy investments are defensive in nature with stable cash flow and solid, but not spectacular, return expectations, this growth is all the more impressive. In comparison, equity investment companies, which have benefitted from a strong bull market over the last three years have grown their asset base by just 26% - though this did amount to a total of £5.4bn due to the large base of existing assets in these companies.

In the equity investment company world, growing assets requires a management team with a solid track record and a clearly differentiated investment strategy.

Within equity investment companies the trend has been to move away from broadly diversified "one-stop shops" and towards more specialised and niche offerings. Sector specialists with a clear value proposition and expertise in a specific industry or market niche have had a much easier time attracting capital from investors. Sector specialist funds have grown their asset base by 56% over the last three years and the large IPOs of Smithson (small cap equities) and Mobius (emerging market equities) confirm this trend as well. Overall, in the equity investment company world, growing assets requires a management team with a solid track record and a clearly differentiated investment strategy that cannot be accessed through cheaper or more flexible products available in the open-ended or index fund universe.

In the alternative investment company world, the main driver of growth has been infrastructure and renewables, but alternative credit funds have also seen significant growth and a broadening universe. While alternative credit is still dominated by senior loans and structured finance vehicles like CLO or ABS, there is a clear shift towards more specialised and less liquid areas of the credit market that promise lower correlation with traditional fixed income and equity investments, together with higher yields. The growth in private debt investment companies (e.g BioPharma Credit, GCP Infrastructure Investments) and direct lending is an example where listed investment companies have a clear advantage over other investment vehicles and provide tangible benefits to retail and institutional investors alike.

Having said that, there is one alternative investment that we should not forget, even though it is not part of the leading sectors by growth: property. The most established and biggest of the alternative investments, property investment companies have continued to grow steadily since the GFC at a rate of 3% to 6% per year. But in this subsector, just like in equities and alternative credit, we can see an increasing shift away from broadly diversified funds towards more specialised niche offerings like Tritax Eurobox in 2018, which specialises in European warehouses.

Fig 3: Leading sectors by growth

Growth last 3 years					
Sector	By issuance (£ million)	Sector	By fund NAV (£ million)	Sector	By fund NAV (%)
Infra / Renewables	4,960	Infra / Renewables	5,544	Infra / Renewables	58
Alternative Credit	3,310	Equity Global	5,443	Sector Specialists	56
Equity UK	2,183	Equity APAC	4,087	Equity APAC	44
Equity Global	1,616.6	Flexible Investments	2,218.5	Flexible Investments	42
Equity APAC	1,559	Equity EM	1,792	Equity EM	38

Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018.

Looking into a crystal ball fogged up by Brexit

The past is just a prologue, as they say, and while it makes intuitive sense that the trends of the last couple of years will persist over the near-term future, the UK overall, and by implication the investment company market, is standing at a crossroads.

At the time of writing, it is still unclear what kind of Brexit arrangement the UK will be able to negotiate with the EU and what impact that will have on the UK economy, and investment companies. Most importantly, demand for investment vehicles, be it equities or alternative investments, depends heavily on macroeconomic variables like economic growth, inflation and the level of interest rates. It was to no small extent the historically low level of interest rates since the GFC that fuelled the demand for alternative credit investments, property and infrastructure funds.

A hard Brexit would undoubtedly lead to lower economic growth in the UK in the short term and potentially higher inflation as Sterling devalues against the Euro and the US Dollar. This in turn would increase the need of investors for inflation protection and stable returns. A soft Brexit with a smooth transition towards a free-trade agreement with the European Union, on the other hand, should boost economic growth in the UK as businesses catch up on investments that have been delayed in the face of Brexit uncertainty. In this case we would have to assume that the Bank of England would increase interest rates rather quickly to fight inflationary pressures. Accelerating economic growth and rising rates are an environment that should benefit equity and private equity investments but could lead to a marked decline in the demand for alternative credit investments.

We have built a two-stage forecasting model that predicts future growth in assets under management of the investment company sector over the next three years (until 2022). The details of this forecasting model can be found in Appendix 2, but the idea is to use different macroeconomic variables to forecast growth in investment companies. We forecast three scenarios:

- **Base case:** This scenario is driven by current consensus forecasts of economists for growth, inflation and interest rates. It assumes real GDP growth of 1.5% to 1.6% per year and a slight decline in inflation from 2.2% today to 2.0% in 2021. The Bank of England is expected to hike interest rates so that 3-month money market rates average 1.3% in 2019, rising to 1.6% in 2020 and then declining again to 1.4% in 2021. Meanwhile, 10-year Gilt yields are expected to rise slightly towards 2.25% by the end of 2021. This is a scenario that essentially assumes a hard Brexit can be avoided and the UK enters an orderly transition phase during which a free trade agreement with the EU can be negotiated and agreed to.
- **Optimistic case:** The optimistic case is derived from the estimates of the most optimistic economic forecasts and is generally congruent with a soft Brexit that leads to a stronger than anticipated increase in economic growth and a Bank of England that is willing to keep interest rates lower for longer in order not to stymie growth. This case assumes a growth acceleration towards 2.2% real GDP growth in 2021 while inflation remains well-anchored around 2.0% and money market rates remain stable at 1.0% for the next three years.
- **Pessimistic case:** This scenario is a hard Brexit scenario without the dire predictions of the most pessimistic economists. It assumes that the UK would drop into recession after a hard Brexit, but the recession would be rather short-lived, and the economy would accelerate towards 1.0% real growth in 2020 and 1.5% real growth in 2021. At the same time, Sterling is expected to devalue, creating an inflation spike like the one the UK experienced after the referendum in 2016. We assume that consumer price inflation would spike towards 3.5% in 2019 but then decline relatively quickly towards 2.5%. The Bank of England is expected to cut interest rates to 0.25% in order to boost economic growth, before hiking again in 2020 and 2021 as the economy recovers.

Fig. 4 shows that the investment company sector has nothing to worry about in our base case scenario. We expect assets under management to grow by c. 11% per year overall, which is in line with the experience of the past decade since the GFC. However, growth in alternative assets is expected to accelerate towards 13.2% per year while growth in the equity sectors remains stable around 10% per year. Looking at the individual sectors, our model indicates that within equity investment companies the largest growth rates should be achievable in the sector specialists' areas and in equity funds specialising in Asian equity markets. The lowest growth rates, on the other hand, are projected for global equity funds and companies focusing on North American equities. This would be a continuation of the trend we have seen in the last few years.

Fig 4: Base case scenario for the next three years

	Cumulative NAV growth (£ bn)	Annual growth rate (% p.a.)
Total	48.8	11.0
Equity	26.5	10.1
Alternatives	20.9	13.2
Flexible Investments	1.4	5.7

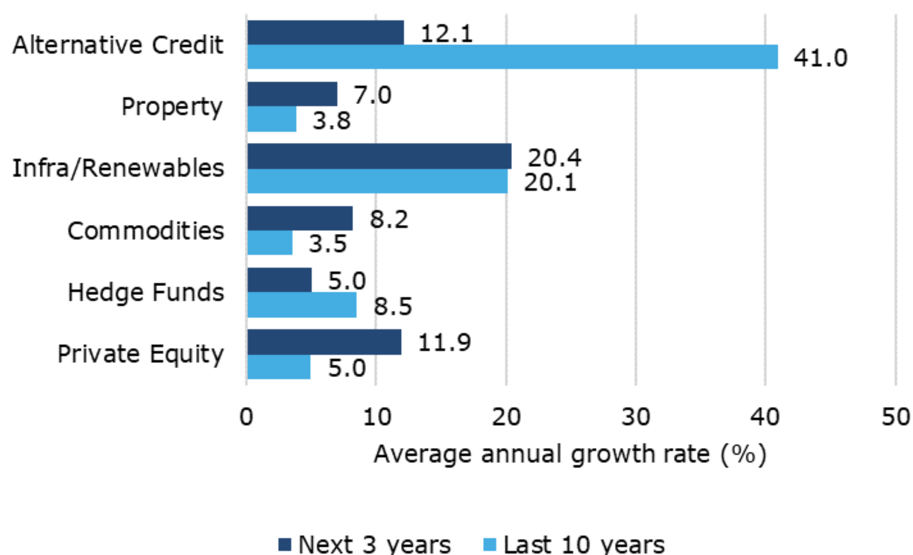
Source: Fidante Capital. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

In Fig. 5 we compare the expected growth rates for alternative investment companies with their average growth rates since the GFC. Unsurprisingly, the sky-high growth rates of alternative credit funds over the last ten years are unsustainable but in our base case projections, alternative credit funds still grow at a remarkable 12.1% per year, outpacing almost all other subsectors in the alternative investment universe bar infrastructure investments. Our base case scenario also projects a continued dominance of infrastructure investments and renewable energy investments within the investment company sector overall. At a projected growth rate of 20.4% (similar to the growth rate experienced over the last ten years), growth in infrastructure investments dominates not only other alternative investments but also all the equity sectors.

Perhaps more surprising than the high expected growth rates for infrastructure and alternative credit funds are the projected high growth rates for private equity funds. At a projected annual growth in assets under management of 11.9%, private equity investment companies take third place amongst alternative investments. Given the media coverage of excessive valuations in private equity transactions and the worries about a potential bear market in listed equity markets sometime over the next three years, it seems counterintuitive that private equity investment companies should experience solid growth.

However, history teaches us that private equity is a typical late cycle investment. As equity bull markets age, returns in listed equities and other risky assets become less reliable and more volatile. In this environment, investors increasingly look for possible replacements that can offer high returns with relatively little perceived volatility. This is not to say that private equity investments are less volatile than listed equity investments, but the less liquid nature of the investments and the infrequent valuations smooth returns over time, providing a sense of security for investors. But within private equity investment companies, the same trends operate, in our view, as in the sector overall. Broadly diversified investment companies are likely to have a hard time growing assets while specialist providers like Augmentum Fintech and Syncona are likely to be the winners in the competition to attract investors.

Fig 5: Projected growth in assets under management



Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

Fig. 6 and 7 summarise our projections for the optimistic and pessimistic cases. These figures show that the investment company sector has a lot more to lose from a bad Brexit outcome than it has to gain from a surprise positive outcome. Growth of assets under management is expected to accelerate to 15.3% per year for a cumulative growth in assets under management of £707bn over the next three years in the optimistic scenario. That is an upside of 4.3 percentage points per year or a cumulative £21.9bn from the base case. In the case of our pessimistic scenario, growth would instead drop to 5.5% per year for a cumulative growth in assets under management of £22.9bn over the next three years. To be sure, this is still positive expected growth, but the gap to the base case is 5.5 percentage points lower growth and a loss in assets of £47.8bn over three years.

Digging deeper into the data shows us that alternative investment companies are subject to larger swings in our projections. Private equity investment companies in particular are likely to suffer in the pessimistic scenario as the assets under management are projected to decline by 4.6% annually in this scenario. Most demand is projected for defensive investments in this pessimistic scenario, with alternative credit investments projected to grow 14% per year and infrastructure investments projected to grow 10% per year.

The optimistic case would reverse the situation somewhat and private equity investment companies are projected to grow at 17% per year in this scenario, almost matching the projected 19% growth in infrastructure investments.

Fig 6: Optimistic case scenario for the next three years

	Cumulative NAV growth (£ bn)	Annual growth rate (% p.a.)
Total	70.7	15.3
Equity	32.3	12.1
Alternatives	36.6	21.5
Flexible Investments	1.8	7.3

Source: Fidante Capital. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

Fig 7: Pessimistic case scenario for the next three years

	Cumulative NAV growth (£ bn)	Annual growth rate (% p.a.)
Total	22.9	5.5
Equity	16.8	6.6
Alternatives	5.8	4.0
Flexible Investments	0.4	1.7

Source: Fidante Capital. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

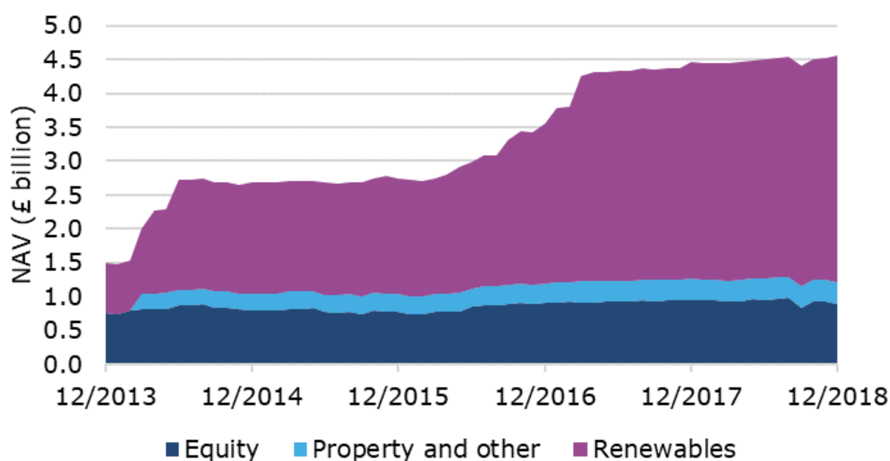
The rise of ESG investments

One area of investments that reaches across all sectors and has shown strong growth in recent years is ESG investment. In its European SRI Study 2018, Eurosif estimates that between 2015 and 2017 assets managed with ESG factors integrated in the investment process grew at a rate of 27% per year. While traditionally dominated by institutional investors, ESG assets are now increasingly sought after by retail investors as well. At the end of 2017, retail investors accounted for 30% of ESG assets in Europe.

In the UK, this trend towards ESG investment has been even stronger, with ESG integrated assets growing by 33% per year between 2015 and 2017 to £2.0tn. And the biggest growth rates are achieved in impact investments, which are still niche at £15.3bn but have grown at a massive 83% annually.

Fig. 8 shows our estimate of ESG assets in the investment company sector. In this figure we include equity investment companies with an explicit ESG focus or a focus on renewable energy (e.g. Jupiter Green) as well as infrastructure investments focusing on renewable energy (e.g. NextEnergy Solar), energy storage (e.g. Gresham House Energy Storage) and similar areas. Within properties we also include (somewhat arbitrarily, we admit) investment companies investing in social housing and healthcare properties, because these investments are typically close to impact investments and oftentimes considered as ESG compatible by investors. Fig. 8 shows that almost all of the growth in ESG assets has come from the vast growth in renewables since 2013.

Fig 8: Estimated ESG assets in the investment company sector



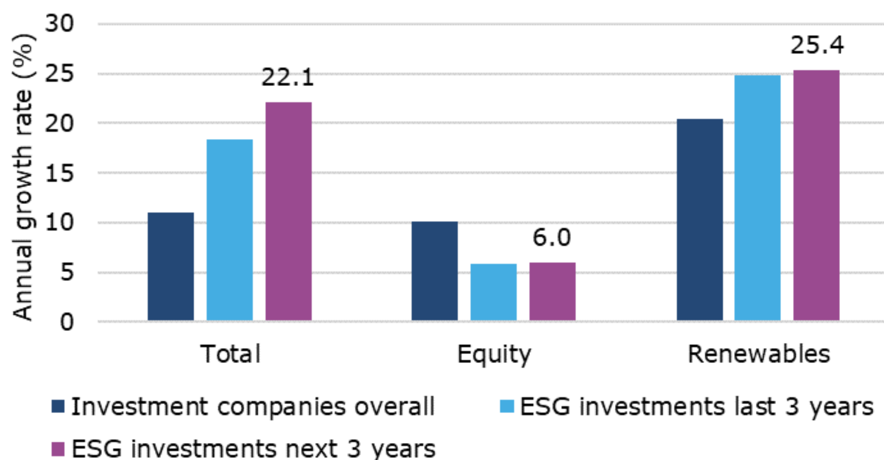
Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018.

If we compare recent growth rates of ESG investments in the investment company sector with the growth rates in the UK overall, as reported above, it becomes clear that the investment company sector has been a laggard so far (Fig. 9). While growth in ESG investments has averaged 18% over the last three years, outpacing overall sector growth of 11% by a wide margin, it is still nowhere near the 27% annual growth rate of ESG assets in the UK overall. Only the 25% growth in investment companies specialising in renewable energy comes close to that number. A shortfall seems to exist in equity investment companies. Equity investment companies explicitly dedicated to ESG investments have grown at a mere 6% per year over the last five years even though this is the sector where ESG integration is easiest and demand from retail and institutional investors is highest.

If there is an opportunity for future growth in the equity investment company universe, it seems to be in specialised ESG funds managed by managers with a good track record and long experience in this area.

Fig. 9 also projects future growth rates for the next three years using the same methodology we used above. Our model projects an acceleration of growth in ESG investments to 22% per year, driven mostly by continued strong growth in the renewables sector and increasingly also in alternative credit and property investments. However, given the shorter history of ESG investments, these projections are more uncertain than the projections for the investment company sector overall. Nevertheless, growth in ESG investments is, in our view, likely to outpace growth in the investment company sector overall.

Fig 9: Estimated growth in ESG assets within the investment company sector



Source: Bloomberg, AIC, Fidante Capital. Data as at 31 December 2018. Forecasts are subject to estimation errors and may deviate significantly from the performance shown.

Summary

In our view, the investment company sector is on track for continued growth in coming years. Our projections show an expected growth in assets under management of £48.8bn over the next three years, for an annual growth rate of 11% per year. This growth is going to be unevenly split, however, with alternative investments dominating issuance and specific sectors within alternative investments, like infrastructure and alternative credit, likely to outpace other sectors by a wide margin.

Another trend that is likely to continue, in our view, is the preference for specialised and differentiated offerings in favour of broadly diversified "one-stop shops". Within equity investment companies, we expect sector specialists and managers specialising in emerging markets and Asian equities to do better than global equity portfolio managers. Within alternatives this trend should create bigger growth in specialist property segments and specialist private equity funds, for example.

Finally, we are witnessing an emerging trend towards ESG investments across the UK and Europe. Within the investment company sector, growth in ESG related assets has already outpaced overall sector growth by a wide margin, yet lagged growth of ESG investing overall. In our view the trend towards specialised ESG investment offerings is here to stay and the investment company sector has ample growth opportunities in this area.

Of course, these projections are subject to uncertainty. This is even more the case at the beginning of 2019 with Brexit looming in a few weeks' time and limited visibility of the impact this development will have on the UK economy and the financial services industry. Our projections show that the economic developments in the UK after Brexit can have a significant influence on the growth of investment companies and that the potential downside is likely greater than the upside at this point in time. However, the good news is that even in our pessimistic scenario, growth in the investment company sector is likely to continue.

Appendix 1: Database description

We have built a database of 547 investment companies, both current and defunct, listed on the London Stock Exchange and the Amsterdam stock exchange between January 2007 and December 2018.[2] We have based our classification on the Association of Investment Companies sectors but simplified it in order to be able to discover general trends per asset class.

As with any market data, some provisos need to be made: first, while delisted and defunct companies are included in the database whenever there was share and NAV data available, not all of them have such data. This means that our data has survivorship bias and may overstate the growth of investment company assets under management in the past. Second, while private equity trusts are part of the database, venture capital trusts are not.

Fig 10: Our sector classifications

Supersector	Sector	AIC sector included
Equities	Equity Global	Global
		Global Equity Income
		Global Growth
		Global Growth & Income
		Global High Income
		Global Smaller Companies
		Split Capital Trusts
	Equity North America	North America
		North American Smaller Companies
	Equity Europe	Europe
		European Smaller Companies
	Equity APAC	Asia Pacific – excluding Japan
		Asia Pacific – including Japan
		Japan
		Japanese Smaller Companies
	Equity UK	UK All Companies
		UK Equity & Bond Income
		UK Equity Income
		UK Growth
		UK Growth & Income
		UK Smaller companies
	Sector Specialists	Sector Specialist: Environmental
		Sector Specialist: Biotechnology/Life Sciences
		Sector Specialist: Financials

[2] The data is based on the monthly publication of the listed investment companies on the LSE by the Association of Investment Companies.

		Sector Specialist: Small Media Comms & IT
		Sector Specialist: Tech, Media & Telecom
		Sector Specialist: Utilities
Alternatives	Alternative Credit	Sector Specialist: Debt
		Sector Specialist: Liquidity Funds
		Sector Specialist: Securitised Debt
		Sector Specialist: Leasing
		Sector Specialist: Litigation
		Sector Specialist: Zero Dividend
	Property	Property
		Property Direct – Asia Pacific
		Property Direct – Europe
		Property Direct – UK
		Property Securities
	Infra/Renewables	Sector Specialist: Infrastructure
		Sector Specialist: Renewable Energy
	Commodities	Sector Specialist: Commodities & Natural Resources
		Sector Specialist: Forestry & Timber
	Hedge Funds	Hedge Funds
	Private Equity	Private Equity
Flexible Investments	Flexible Investments	Flexible Investments

Source: AIC, Fidante Capital.

Appendix 2: Forecasting methodology

Stage	Method
Stage 1	Estimate future returns of the FTSE 100 index based on its relationship with return last year, 3-month and 10-year interest rates at the beginning of each year, as well as real GDP growth and CPI during the year. Predictions for interest rates, GDP and CPI are consensus forecasts from Bloomberg.
Stage 2	For each of our sectors, we estimate annual NAV growth based on its past relationship with FTSE 100 returns, 3-month and 10-year interest rates at the beginning of each year, as well as real GDP growth and CPI during the year. Predictions for interest rates, GDP and CPI are consensus forecasts for Bloomberg.
Forecasting NAV growth	Based on the forecast growth rates for each sector we calculate the growth of NAV. NAV growth for each sector is then aggregated over our three supersectors.

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