

The burgeoning role of secure income

A better way to meet your obligations
to savers and planet



Revisiting our industry obsession of holding zero* return, zero* income, liquid assets with an expected decade plus holding period (*not quite zero, but very close).

**What problems are we trying to solve?
And why do Real Assets play a peripheral role?**

The investment management industry should ask this question more often. What are the problems facing long-term savers and how does a particular asset allocation or investment product help?

Funds designed by investment managers can often be peer driven, leading to “me too” strategies with a priority on scalability rather than what investors need. In real estate we see many core strategies with large allocations to office and retail sectors on short leases. Or infrastructure strategies with lots of “demand risk” (or non-contractual revenue). While these may be perfectly reasonable investments, these types of real asset strategy can target returns which are higher than what most institutional savers need to meet their overall objectives and exposes them to meaningful risk over the long-term certainty of cashflows.

Without a greater focus on understanding the specific needs of the end saver, Real Assets can be confined to a relatively peripheral role in client portfolios. We observe a 5-10% allocation to Real Assets is fairly typical.

The institutional investment “norm”, particularly within the pension fund industry, is for traditional government and investment grade corporate bonds to play a dominant role in providing liability matching characteristics, being a defensive asset class and delivering a stable income stream. But is that accepted industry norm right? And is now a good moment to revisit, acknowledging that those government and investment corporate bonds currently offer close to zero income and zero return potential?



Solving the key challenge facing defined benefit pension funds

The sustained bull market experienced in growth-related assets has helped to swell the value of assets held by pension funds, and in many cases driven a reduction in the deficit (the asset value minus the discounted present value of future liabilities). This is providing an opportunity for many pension funds to de-risk. But with increasingly mature schemes entering a cashflow negative phase (the required income to pay beneficiaries is greater than the income generated from the asset portfolio), the need for income generative assets is significant.

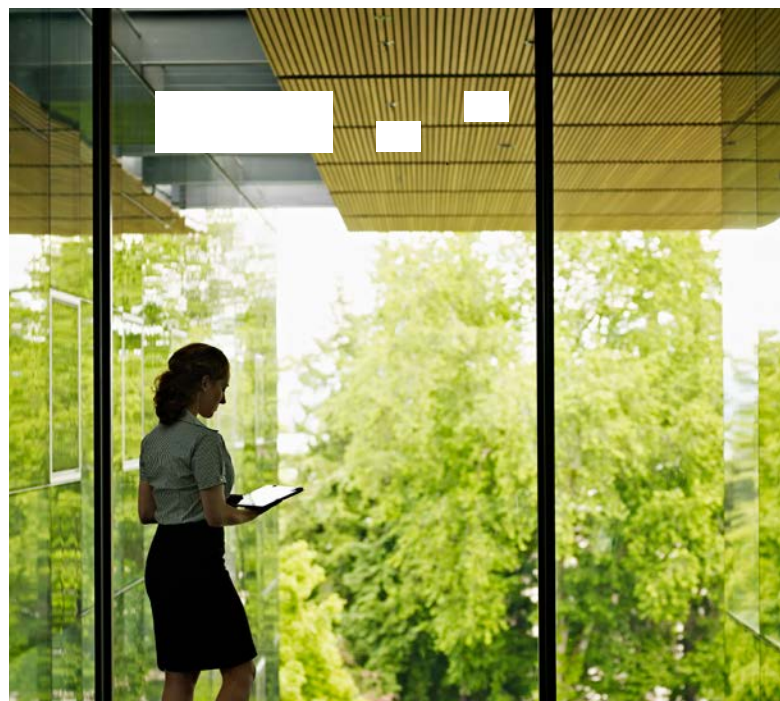
Unfortunately, the favoured instruments for de-risking, namely high quality government and corporate bonds, now fail the dual requirement of low risk and healthy income generation. Investors increasingly receive very low income levels on high quality government and corporate bonds as central bank actions have pushed interest rates down to historically low levels.

We believe there could be strong demand for real asset strategies that can address these needs by displaying specific characteristics:

- Long term contractual cashflows from a real asset (often contractually inflation linked)
- Strong counterparties, ie low risk
- Expected returns ahead of liquid bonds with similar risk
- Simple and understandable assets which add value to society

We call these strategies “Secure Income” and they are defined by cashflow and risk characteristics rather than asset class or sector labels. Importantly they solve the challenge of low risk and a reasonable level of income generation, with a target of achieving a 3% premium over high quality bonds. Consequently, they are well placed to meet a specific need in institutional investor portfolios.

A key part of the higher income generation comes from an embedded “illiquidity premium”, which ranges from 2% to 4% per annum. Investors are paid a premium to invest in Secure Income given it requires a longer-term investment horizon. Given that defined benefit pension funds are maturing, do they still have that long-term investment horizon? In our opinion, the answer is typically yes. The investment horizon for a defined benefit pension fund is typically similar to the tenor of Secure Income assets. There is scope to embrace some illiquidity and exploit the attractive additional returns and income offered, rather than exclusively holding



high liquid (government bond) assets on a buy-and-hold basis. And even for those pension funds contemplating an earlier exit through buy-out, there is a functioning secondary market in these assets. Furthermore, we might find that the buy-out insurer will consider retaining these assets as part of the transaction.

To date, the typical allocation to Secure Income assets (where an allocation has been made) has remained modest at around 5% of total assets. However, for those investors that have embraced secure income, the most advanced are building allocations towards 10% or 20% as the long term, benefit payment-like, income stream is seen as strategically important to a maturing pension fund's assets. We expect this trend to continue.

Is this just a UK phenomenon?

No. The needs of investors and the challenges faced (outlined above) are global in nature. And while the Secure Income concept is more established in the UK and there is a broader range of suitable and available assets, we believe there is global applicability and expect adoption will grow. Importantly, this will require greater engagement between asset owners, asset managers and issuers.



Global examples of secure income assets

1. US social infrastructure – waste water recycling

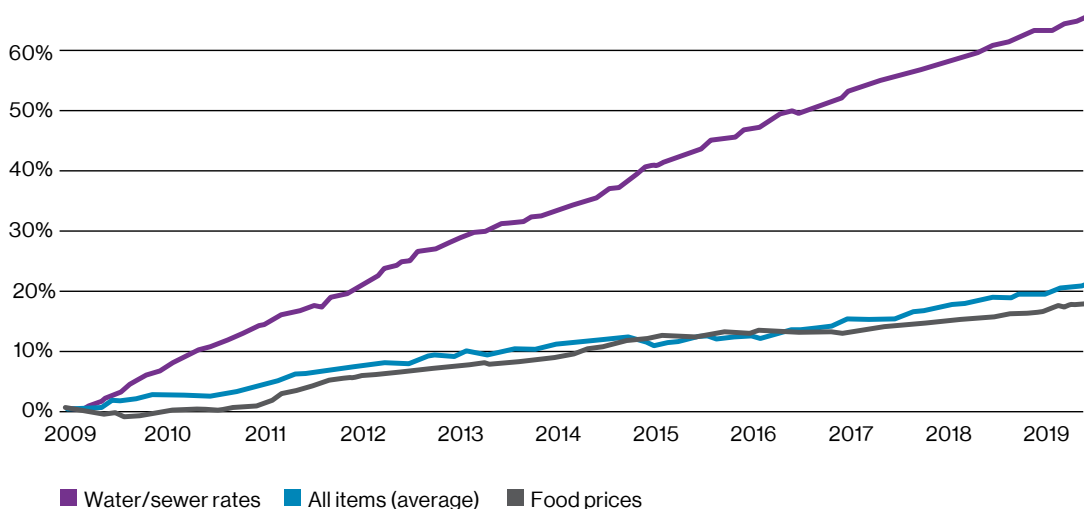
We have helped several clients invest in a low risk US infrastructure fund that invests in waste water recycling facilities for large institutions like universities or hospitals. The waste water facilities allow users to materially reduce their primary water needs and waste costs. Municipal waste water charges have risen by 3.3% per year over 2008 to 2016, and general water and sewer rates have materially outpaced inflation since 2009. This has led to companies wanting to build their own water infrastructure to reduce long term costs.

Investors benefit from a long term (15 to 30 year) contract with the user, with annual payments increasing in line with utility rates, less a contractual discount. Typically, the counterparties are investment grade quality and the unlevered annualised returns are around 7%* – an attractive illiquidity premium.

The waste water facility uses an eco-engineered process (which includes the use of plants and microbes) under proven technology and often uses solar panels to offset the energy required. In a specific case study, it is projected that this will lead to a 42% reduction in waste water discharge and 34% reduction in water use.

These assets are well positioned against a backdrop of likely increasing water regulations over time, as the water supply becomes more constrained. California has already introduced water restriction legislation to reduce the overuse of underground aquifers.

Figure 1. What Americans pay for water and sewer service has increased much faster than inflation or the price of food



Source: Bureau of Labor Statistics – Consumer Price Index

2. Australian healthcare real estate

Another sector that plays into the sustainability theme as well as being an attractive sector for our clients.

Historic returns show the healthcare sector has achieved higher returns with lower volatility compared to traditional property sectors and is supported by thematic tailwinds such as an ageing demographic and technological advances in medical treatment. To further ensure that the risk profile of the sector became even more attractive to secure income investors, we worked with an Australian manager to design and structure a healthcare property fund with long leases and clear restrictions around leverage and tenant exposure.

One of the assets purchased was a recently renovated private hospital specialising in psychiatric treatment and specialised addiction therapy. Investors received a rent set at a level representing c.40% of the hospital's profitability, making it affordable. The rent translated into a c.6% initial yield which, when combined with contractual uplifts on the 20 year lease length, provides investors with an attractive return of c 7.5% on an unlevered basis*.

3. Euro renewable energy

Given the strong tailwinds supporting the renewable energy theme, we partnered with a market-leading investor to produce a product that invests across solar, wind and hydro operating projects. Renewable energy is an attractive secure income investment as it provides predictable electricity, which is then sold through long term contractual arrangements, either government subsidy schemes or through corporate Power Purchase Agreements (PPAs).

Through this fund our clients own a 150 megawatt wind farm positioned on the Stavanger Fjord in Norway that benefits from high and predictable wind speeds. The asset sells its

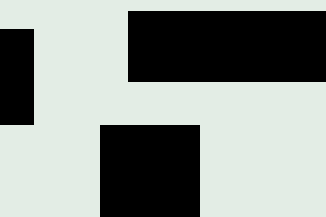
electricity via a 10-year contract (with a utility) which provides contractual returns, and also receives subsidy payments. The contractual energy price is set somewhat below current market prices. With modest leverage, the expected annualised return from the asset is 9%*.

4. UK temporary housing

We worked with a manager to design and structure a temporary housing accommodation fund. This was the first fund of its type in the UK market place which provides refurbished accommodation for the homeless, which includes rough sleepers, victims of domestic abuse, those with addiction issues, veterans and those recently released from prison.

There is a severe shortage of accommodation for the homeless in the UK, which has increased in recent years. Given the legal requirements to support the homeless, this has resulted in Local Authorities housing the homeless in unsuitable accommodation at considerable cost.

The fund helps to address this societal issue by creating new homeless accommodation on long leases to housing associations let on low rents. This provides an affordable long-term solution to Local Authorities – in several cases the local authority is saving 60% relative to the cost of bed and breakfast accommodation. Investors own the assets via a fund and receive long term contractual, inflation-linked, income.



*Past and expected performance is not a reliable indicator of future returns



Building secure income portfolios

When building securing income portfolios we believe it is important to:



Set out your objectives and beliefs

Given the broad definition that the market provides for secure income, it is important to understand exactly what you are looking to achieve from secure income and ensure that you are well positioned to work with partners that are well-aligned with what you are trying to achieve.



Diversify

Although we believe individual strategies are low risk, they are typically exposed to “left-tailed” risks or low probability events which could have a material impact on projected cashflow. Examples of this include adverse political or regulatory intervention. For example, in our Australian healthcare example above this might be regulation which materially weakens healthcare operators. Or in the case of UK temporary housing it may be political decisions to reduce the abilities of local authorities to spend on homeless solutions. As a result, we believe investors should diversify across multiple strategies to minimise the impact of these extreme risks.



Find local experts

To effectively source and operate these assets often requires specialised local fund and asset management skills. We believe strong managers need to have a clear framework to price the key risks being faced, including illiquidity. They also need to retain a focus on the underlying asset quality, despite the main target being contractual income stability, as this tends to limit the downside risks.



Monitor look-through risk exposures

At an aggregate portfolio level it is important to assess the look-through exposures to multiple risks such as counterparties, countries, political, regulatory risks as well as sustainability related risks such as the potential impact of climate change and resilience against natural perils.

Sustainability is inherent

We increasingly see pension fund beneficiaries and corporate sponsors wanting to see investments that have a positive impact on the planet, or at the very least, not have a materially negative impact.

The Secure Income space offers significant scope to target investments with a positive impact on the environment and society.

For all of the secure income strategies we research, we believe sustainability to be an important and inherent consideration. By definition, secure income strategies are long term and a successful outcome requires consideration of how the asset is creating value for local communities or broader society. Investing in projects where there isn't a clear link to how society benefits, is likely to cause public dissatisfaction and, over time, potentially adverse regulation or political action. Assets being developed need to reference local communities and demonstrate the sharing of benefits. Finally, property owners, even with long leases, need to engage with tenants to work on ways to improve building energy efficiency as regulations get increasing tough.

Summary

As we enter a new decade, the investing environment is becoming increasingly more challenging. While we cannot predict future returns, success is more likely to result from focusing on investor objectives and increasing the resilience of investor portfolios. In this context, secure income strategies with their long term, often inflation-linked, contractual cashflows, remain very attractive strategies for de-risking pension funds that can embrace illiquidity.

We have been working in partnership with our clients and skilled investment managers to structure, improve and design products to target high quality secure income assets in a sustainable manner.

Further information

For more information, please contact your Willis Towers Watson consultant or:

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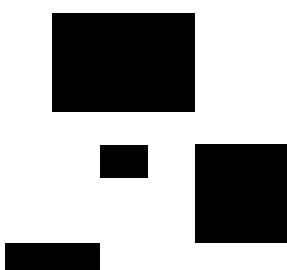
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