Private assets: this is how ABP approaches it

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For this winter edition of Private Assets, we spoke with Martin van der Pot. He is Head of Private Investments at ABP and has gained experience throughout his career at several pension funds and the Dutch Central Bank (DNB), both in a risk management and fiduciary capacity. For many years, ABP has maintained a substantial portfolio of various private assets, managed both by its administrator APG (ABP refers to this as "internal" for convenience) and by external managers.
Martin is therefore the ideal discussion partner for VBA Journaal readers to discuss this topic from a policy and implementation perspective of a large pension fund.

ORGANIZATIONAL SETUP OF ABP MANDATE MANAGEMENT AND GOVERNANCE

Martin begins by describing the structure of the investment department at ABP and then its relationship and collaboration with APG. In addition to a Strategy team, ABP has two mandate management teams: one for liquid markets and one for private assets. These two mandate management teams are further subdivided into specialists for each asset class. A total of nine people work in mandate management. Martin leads a team of four people responsible for private assets. His role is that of a working foreman.

Within private assets, a pilot and co-pilot have been appointed for each asset class. Martin is the co-pilot for Infrastructure, Real Estate, and Private Debt.

Martin explains that ABP has brought part of its financial advice and mandate management in-house for several years now.
Martin: *"APG advises on ALM, strategic asset allocation (SAA), and sustainability. We are responsible for mandate management and decide how an investment category is structured. Naturally, we utilize the expertise of APG and the external managers in this process. Mandate management involves describing the investment mandate and the framework within which it must be executed. This includes the regions in which investments are made, the indices used, and the selection of the asset manager(s). ABP decides on the choice between internal and external managers (editor's note: he will elaborate more on this later). We also determine the weighting between internal and external managers. Subsequently, the specific manager selection process generally follows the advice of APG's External Management Selection team."*

Martin explains that ABP mandate management supports the APG teams monitors and evaluates periodically. This is primarily done on a quarterly basis, supplemented by a thorough review every three years per asset class. They can also use external consultants for this purpose. These reviews explicitly focus on the quality of the execution. For internal management, either *Operational Excellence* or *Product Leadership is central.* Martin explains these

Martin van der Pot

Martin has worked at ABP since 2023, where he and a team of four colleagues are responsible for managing private investments. Previously, Martin worked at PGGM Risk Management and Fiduciary Advice, and as an investment specialist at De Nederlandsche Bank (DNB). He still serves on DNB's own company pension fund and, as a director, is responsible for the investment portfolio.

Concepts from: *'Operational excellence is good, more or less standard, execution at market-based costs. That's what we assess. Product leadership is a distinctive activity in which, as the term suggests, the APG team is expected to be at the forefront of the market in several aspects.' For private categories, we often invest internally due to product leadership. We speak with numerous external parties and consultants to determine whether this is truly a distinctive approach.*

He continues: *'For monitoring the mandates, ABP uses its own framework consisting of 6 main criteria for assessing the teams, including well-known criteria such as people, process, track record (performance & risk), planet and philosophy.'*

CHOICES ABOUT INTERNAL VERSUS EXTERNAL EXECUTION

ABP has a fiduciary administrator, APG. They have a close relationship. Therefore, we will examine in detail how the choices and decision-making process are made when allocating (partially) to the fiduciary versus external managers for the Private Assets.

Martin explains this in detail. *"The choice between internal and external management is based on ABP's investment beliefs, investment costs, track record, product leadership, and operational excellence. Our investment beliefs are public. We've also elaborated on them in more detail so that we all (both within ABP and APG) know what these concepts entail. We're pleased to have this. This clarifies mutual expectations, allowing us to hold each other accountable."*

He indicates that input for the track record (return, risk) is provided by APG, but in accordance with ABP's requirements and wishes, including the use of other benchmarks where appropriate. For assessing product leadership and operational excellence, input is primarily gathered externally.

LIQUID MARKETS

Martin then explains: *"For the listed categories, a portion is always outsourced to ensure business continuity. These mandates are also more externally comparable and therefore easier to benchmark. The differences in management fees are also small. Finally, it's easier to switch more quickly between internal/external assets within listed companies due to the low transaction costs or in-kind transitions."*

PRIVATE ASSETS

Martin then adds: *"With private clients, the trade-off between internal and external management is more complex. There are significant cost differences, especially with Private Equity (PE). There are also no options for quickly and inexpensively switching between managers, partly because in-kind transfers aren't possible."*

As a result, ABP typically has the vast majority managed internally by APG. However, it can then supplement this through multi-managers in these categories for benchmarking and diversification. In these cases, ABP has two multi-managers: APG as its preferred partner and a specialist manager who handles a smaller multi-manager mandate. This keeps everything objective and businesslike, according to Martin.

The end result is that depending on each category a choice is made about the implementation of the type of internal management of the private asset class.

In Infrastructure and Real Estate, the APG team invests directly in individual investments, while in PE, investments are made through both fund investments and co-investments. ABP aims to significantly expand this latter category, partly due to the significant cost advantages (i.e., the absence of management and performance fees) it offers compared to fund investments.

Martin then adds: *"Unlike Infrastructure and Real Estate, PE doesn't invest directly. The reasons are that this is a labor-intensive activity, requiring extensive knowledge, experience, and a vast network. It also entails a completely different compensation policy to attract these types of skills and thus individuals. The required high salaries and bonuses don't fit within the internal compensation policy."*

ABP periodically evaluates whether it should maintain its policy of not making direct PE investments.

PERFORMANCE FEES WITHIN PRIVATE EQUITY IS A POINT OF ATTENTION; WE WANT SIGNIFICANTLY MORE IN CO-INVESTMENTS INVEST TO TO REDUCE COSTS

For a new strategy, such as impact investing within PE, where APG had no track record at the time, a conscious decision was made to combine internal (self-selecting funds and GPs) and external (multi-manager) allocations. The majority of the allocation goes to APG, which ensures a steady buildup, but a small portion is managed externally to facilitate learning and market knowledge. Within PE, there is also a small allocation to Venture Capital, which is primarily focused on impact investing, where they can take direct stakes.

Regarding the governance and monitoring of the private assets managed by APG, Martin notes the following: *"ABP has no active involvement in APG's internal management of the private asset classes. This concerns discretionary asset management. We do receive all investment proposals from the investment committees of the APG private teams. ABP can then raise questions, but it has no veto."*

Martin praises this transparency and mutual consultation approach, continuing: *"It strengthens trust between both organizations and reduces the information asymmetry between us as the Principal (ABP) and the Agent (APG). This, in turn, reduces the knowledge gap. ABP remains well-informed about the opportunities and risks in the portfolio, and unnecessary restrictions in the mandate structure are avoided. This also allows ABP to better explain its reputational considerations to the executive teams."*

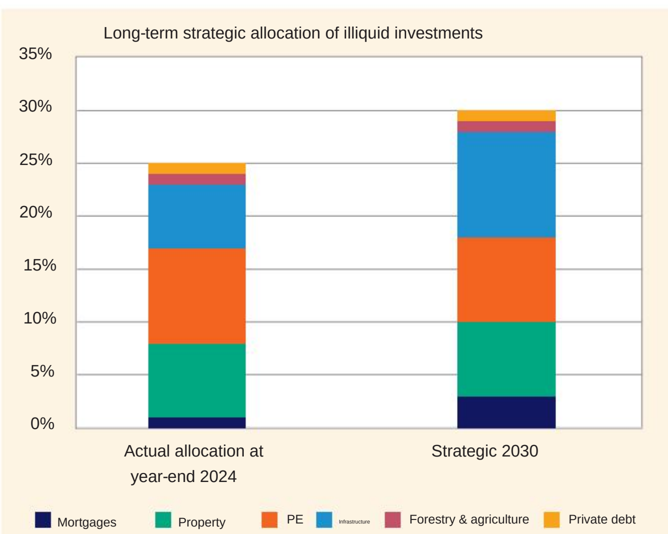
STRATEGIC ALLOCATIONS TO PRIVATE ASSETS

PRINCIPLES AND MAXIMUM PRIVATE ASSET

Next, we consider the development of the strategic asset allocation (SAA) to the private categories. Martin explains: *"The SAA is determined periodically through ALM studies, with APG providing advice. The individual asset classes are modeled separately, i.e., individually for PE, Infrastructure & Real Estate. The maximum share of private assets, or the total illiquid investments, is determined separately based on stress tests. This involves, among other things, the following questions: What do you need for liquidity purposes? What do you need to be able to rebalance? What do you need to restore a healthy risk profile?"*

Martin continues: *"Once this maximum for private assets is established, the ALM model will determine a suitable asset mix. Currently, ABP invests approximately 25% in private categories (excluding mortgages), which is well within the maximum. The board explicitly accepts that the weighting of private assets may temporarily increase during market shocks.*

Figure 1
Long-term strategic allocation of illiquid investments



Source ABP

We ask whether and to what extent ABP's investment beliefs regarding returns, risk, costs, and sustainability are reflected in the ALM and SAA considerations. Martin indicates that transparency regarding and the level of costs play a clear role in the SAA. In certain scenarios of high PE returns, you also face high performance fees. This is particularly sensitive in years in which indexation is not possible and/or not implemented, such as 2018-2020. However, due to the new pension system, in which pensions are more closely aligned with returns, combined with increased transparency, the risks of such scenarios have become less significant.

INFRA VERSUS PE WEIGHT

To better understand the considerations regarding allocations to individual private assets, we discuss a specific case: The target weight for Infrastructure is significantly higher than for PE, namely 10% versus 8%.

Martin explains: *"Infrastructure has a very favorable risk/return profile, especially the way ABP invests in it. The inflation component is also attractive and provides excellent diversification within the overall portfolio. We can also invest directly through APG, which significantly reduces implementation costs. Overall, it aligns very well with our investment beliefs, partly because these are investments that have a direct impact on society around us.*

TRANSPARENCY ON INVESTMENT PROPOSALS REDUCE THE KNOWLEDGE DIFFERENCE BETWEEN ABP AND APG

Martin then explains that ABP primarily invests in two more defensive, low-risk segments of infrastructure.
The investments and thus cash flows are based on concessions, investments with a primarily monopolistic nature and where supply is limited. ABP invests less in the riskier spectrum, which entails greater development risk. This segment, with its higher risk but also higher expected returns, has a smaller weighting within Infra. This segment includes investments in (Dutch) wind farm development and battery storage.

SUSTAINABILITY, SAA & ALM

Since sustainability is a key issue for ABP and its participants, we asked whether and how this is factored into the ALM calculations and subsequent asset allocation decisions. Martin: *"It's not directly included quantitatively, except that the impact of climate change is reflected in the economic scenarios.*

Specifically, through economic growth. Further ALM calculations now incorporate three dimensions: return, risk, and costs. The fourth dimension, sustainability per category, is incorporated via a qualitative overlay, with a plus or minus depending on the sustainability score. While each category receives a score for ESG opportunities and risks, it is not directly optimized for. Infrastructure and Forestry, for example, score a plus in this area.

DILEMMAS AND CHALLENGES IN PRIVATE ASSETS FROM STRATEGIC PERSPECTIVE

Besides the high(er) costs of private assets, Martin tells us about one of the other dilemmas when investing in private assets.
The goal is to capture premiums for illiquidity and complexity. This requires conviction, discipline, and perseverance. Sometimes private assets can lag liquid markets for extended periods, or new balance sheet dynamics can emerge. In such cases, you don't want to be forced to sell.
This requires that you, as a department, closely monitor and understand these dynamics. You must then ensure that you properly inform the board about this, as well as about the implications of strategic choices and the need for policy consistency. In other words, continued stable investment to reap those liquidity premiums. I also consider this one of my most important responsibilities as a private assets manager: ensuring that the board knows exactly where it's investing for the long term, what can happen, and how to handle that in private assets. You also need to be able to clearly explain exactly what's happening in the markets, because board members will rightly ask critical questions.

It is then not enough to indicate that things will turn out well in the long run.

MANDATES AND CONTROL OVER IMPLEMENTATION AND RISKS

Next, we discuss how ABP and Martin's private assets team maintain control over the quality of execution and risks. ABP has mandates for each category.

These mandates have a partially similar structure for private assets, but also differ depending on the type of execution. A common element is that all individual real estate and infrastructure investments are classified using their own risk classification consisting of 4-5 levels.

According to him, this risk classification is the most important management tool for setting limits within the category. An investment's risk classification consists of a qualitative and quantitative assessment of, among other things, the certainty of the investment's cash flows.

Such an assessment is possible because these investments are managed internally. Therefore, you can also better manage regional allocation and return/risk.

ABP HAS THE RISK APPETITE TO
TO DEVIDE FROM THE LONGER PERIOD
TARGET ALLOCATIONS FOR PRIVATE ASSET
Classes in specific scenarios

Martin explains that this is different for PE: *"With PE, investments are made in so-called blind pools because you don't know in advance how the private equity General Partner (GP, ed.: asset managers of PE funds) will invest in a sector and/ or region. This means there's less control, and there are wider bandwidths for concentration limits for single asset, country, and individual manager risk.*
He also notes that private assets also have limits for leverage and development risk (infrastructure, real estate).

SUSTAINABILITY ASSIGNMENTS IN MANDATES

We then incorporate sustainability into the mandates. ABP adheres to the Net Zero Investment Framework (NZIF)2 and mandatory engagement paths for portfolio sustainability. We apply this to the underlying companies. For infrastructure and real estate, we do this for both existing and new investments. For PE, there's no control over the existing portfolio, and we primarily engage with the PE GPs to ensure that new individual assets comply with the NZIF framework.

He emphasises that sustainability and returns cannot be viewed separately, especially not in the case of private assets.
If an asset isn't made sustainable, he expects it will be sold at a lower price in the future. *"Sustainability requirements will only increase in future financial markets, resulting in higher discounts being imposed on companies that haven't done enough to mitigate and manage sustainability risks."*

Finally, Martin summarizes the benchmark design for the private asset classes. *"ABP essentially uses three types of benchmarks: a main benchmark primarily for SAA and ALM, an execution benchmark, and an absolute benchmark. We look at all three to monitor the strategic results and execution of the respective asset class."*
For PE, this translates into the following three benchmarks: Listed All World Equity plus a premium, a Peer Group benchmark (Customized Burgiss), and an Absolute Return benchmark (after costs). For infrastructure, the main benchmark is a Customized combination of Government Bonds, MSCI Transportation, MSCI Utilities plus a premium, and for real estate, it's an MSCI Index.

LESSONS FROM THE PAST: RISK STACKING AND GOVERNANCE RIGHTS

Since ABP has been investing in private assets for many years, it has naturally had both positive and negative experiences.
We ask about this and how so-called lessons learned have been incorporated into her policy.

Martin: *"I can't comment on individual investments, but generally speaking, we've noticed we need to be wary of risk accumulation. By this, we mean, for example, the combination of an investment with development risk, with a new partner, and also in an emerging market. Each risk may have been assessed individually and assessed as controlled and acceptable, but the sum total is still too much. We've been focusing more closely on this to avoid this, both at the mandate and individual asset level. The returns realized in emerging markets have been disappointing on several occasions in the past. As a result, we've become more selective with private assets in emerging markets. There, there's often (more) development risk, and your rights as a financier are less certain (editor's note: rule of law).*

HARVESTING LIQUIDITY PREMIUMS
REQUIRES DISCIPLINE AND CONVICTION; YOU
AS AN INVESTOR, YOU MUST REMAIN STABLE,
EVEN IN THE EVENT OF DISAPPOINTING PERFORMANCE
COMPARED TO BENCHMARKS

Another important lesson from the past concerns governance rights as a major investor. Martin explains: *"ABP and APG have traditionally been major investors in funds or structures (such as joint ventures and co-investments) of private managers. This allows us to demand more regarding governance, voting, and approval rights. Think of the right to dismiss the manager, to appoint supervisory directors, and to approve a business plan. APG has therefore often negotiated substantial governance rights on behalf of ABP in the past. In good times, the question is sometimes asked: do you really need all that, because it takes a lot of time and money? But we've seen that when a manager's performance declines, it's precisely the governance rights that are most valuable."*
In other words, when structuring investments, we focus on strong governance rights.

INVESTING IN THE NETHERLANDS AND IMPACT INVESTING

ABP represents participants from many (government) sectors in the Netherlands. Pension funds are feeling pressure from many quarters to invest more in the Netherlands and to pay specific attention to their own sectors. We want to know how ABP is handling this. Martin begins by stating that this is certainly an issue at ABP. Finally, she knows a very diverse group of stakeholders. *"That's one of the reasons why we have a specific program for Investing in the Netherlands. This is part of ABP's goal of having €30 billion in Impact Investing by 2030 (4% of the balance sheet).3 Of the €30 billion, we want to invest €10 billion in the Netherlands. We consider this a significant ambition because we attach strict criteria to the impact investing classification. This means, among other things, a clear Theory of Change4 of the investment, intentionality, measurability of, and reporting on the asset's impact results. Consequently, only private investments can be classified as impact investments at* ABP.5

"WE HAVE BECOME MORE SHARP ON "ACCUMULATION OF RISKS"

We asked Martin if and how concessions are made on criteria like return and risk to enable impact investments. Martin resolutely: *"No. An impact investment must be right on all fronts of sustainability, return, risk, and costs."*

Of course, we can accept a lower return if the risk is low. Consider our investments in affordable rental properties in the Netherlands. In this category, we accept the lower return only for very low risks. The low risk appetite (no and/ or very limited financing and development risk) associated with low-yielding affordable rents means that many projects are unattractive to us. These projects yield too little for the risk they entail. At the total mandate level within real estate, this is combined with investments with a higher return/ risk profile, so that the long-term expected return and risk of the allocation to real estate are also at the right level.

In addition to the "axis" of investing in the Netherlands, we discuss how ABP handles investments for its own sectors. Martin uses the example above: *"Investments in affordable rents are, of course, also beneficial for a large portion of our participants. This includes teachers, police officers, and firefighters. Furthermore, affordable senior housing is important for our retirees.*

SUSTAINABILITY THEMES AND RECENT DEVELOPMENTS

In addition to the above, we discuss ABP's Focus Themes. These include climate transition and nature conservation, biodiversity, the circular economy, sustainable food and agriculture, affordable housing, healthcare, and education.
Examples of impact investments include the aforementioned affordable rent, investments in Infrastructure for the Energy Transition, and providing startup and growth capital within the VC mandate. Martin admits that investing in biodiversity and circularity remains challenging at the moment. This is due to the availability of sufficient investments. Both in terms of quantity and size. Martin emphasizes that impact investments at ABP are not limited to its Focus Themes.

SUMMARY AND CONCLUDING REMARKS

Martin van der Pot, Head of Private Markets at ABP, took us into the institutional world of private assets.
He extensively discussed the design, governance, and decision-making regarding both strategic allocations to private assets and individual choices within private assets. We discussed the criteria and decision-making regarding internal and external management, or combinations thereof, by its fiduciary manager, APG. Martin also discussed the lessons ABP has learned from past investments in private assets and how these have been incorporated into its policy and implementation. Sustainability and impact investing play a significant role in investments in private markets because the investor has and/or can have more direct influence. To implement and shape sustainability, no concessions are made on returns, which also limits the universe of available investments within these categories. ABP recognizes the impact of these choices. Martin also explicitly emphasized that investing in private assets requires discipline to collect long-term premiums, but also that it is associated with high costs, particularly for PE.

ABP is trying to reduce the impact of this through choices regarding implementation and management.

IMPACT INVESTMENTS MUST FIT ALL AXES: SUSTAINABILITY, RETURN, COSTS AND RISK.
NO CONCESSIONS ARE MADE

In our opinion, ABP, through the above interview, provides readers with valuable information about the choices made by a major Dutch institutional pension investor regarding policy and private asset management. This includes the role of transparency, effective dialogue, and the importance of a disciplined approach, including clear choices regarding risk management, costs, and (participant preferences) regarding social issues, including sustainability.

Nuts

1 For this, see: https://www.abp.nl/content/dam/abp/documents/investing/investment beliefs.pdf

2 See more about this at: https://www.iigcc.org/net-zero-investment-framework.

3 See more about this at: https://www.abp.nl/content/dam/abp/documents/investing/investment-impact-policy.pdf

4 See more about this at: https://www.theoryofchange.org/what-is-theory-of-change/.

5 An exception to this are primary issues of a Corporate bonds. However, these must still meet requirements regarding, among other things, the Theory of Change, intentionality, and measurability of impact.