Perspectives Podcast “Investment Trends in Focus: Quarterly Roundtable Q2 2024”

Transcript, 25 April, 2024

Adam Bass (00:03):
This is MSCI Perspectives bringing to light insights and analysis that help global investors tackle today's challenges. I'm your host, Adam Bass, and today is April 25th, 2024. It may be hard to believe, but another quarter has gone by since we last had the chance to listen in as MSCI's chief Research Officer Ashley Lester and a panel of experts from his team discuss [00:00:30] the state of the markets. This go-around, it was a robust discussion of the public and private markets as well as a deep dive and some surprising results from the world of sustainable investing. Here's that conversation now. I'll see you on the other side.

Ashley Lester (00:49):
Hello everyone and welcome to the MSCI Perspectives podcast for the first quarter of 2024 where we explore the most pressing issues facing investors around the world. [00:01:00] I'm Ashley Lester, the chief research officer here at MSCI, and today I'm joined by a panel of MSCI experts who will share their insights and perspectives on investment issues around the world as their evolving this year. We'll be covering a range of pressing topics today from the ongoing rally in public equity markets through the importance of governance and of ESG more broadly to investment risks and returns and on to the growing world of private assets, including private [00:01:30] credit and perhaps the ways in which private assets might come to resemble public assets more than they do today. All this involved, we'll be discussing with three experts from MSCI research. Today we're joined by Anil Rao from our solutions research team, Laura Nishikawa, who leads our ESG research team and Louis O'Shea who heads our private asset research team. Anil, I might start with you. Public markets continue to rally up eight or nine [00:02:00] percent already this year. What continues to drive this rally and is it a continuation of the story that we saw last year around concentration and AI?

Anil Rao (02:10):
Yeah, thanks for the question, Ashley. And hello Laura and Luis. So we spoke last on this podcast, Ashley, in late 2023 and the story then, as you mentioned, was surging equity markets and choppy bond markets. And here we are, a quarter into 2024, and it [00:02:30] feels like as Yogi Beria said, it's deja vu all over again. Global equities are up, they're now up around 3%. They've given back some of those gains over the last week, but they're up importantly about 15% over the past trailing year. Government and investment grade corporates across most major markets are off as the higher for longer scenario seems more likely given unexpectedly high inflation. And last week's inflation print that we saw that hit US bonds, [00:03:00] the Iranian strike hit fear indicators such as VIX and equities as I mentioned, gave back in a little of their gains. But let's maybe unpack that a bit further and think through how someone rebalancing their portfolio might react to all that.
(03:14):
So one observation is that the broad market, what I just described, that 3%, that obscures what are some notable post-COVID regional patterns. So let's just take equities for example. What are for global equities? So we have this global [00:03:30] index, it's 45 some odd countries, 10,000 some odd stocks, five major regions, some style segments, some size segments. Over the past year, two regions are worth highlighting. One is the US, the second is Japan. Those two have led all regions, while Chinese equities have continued to struggle. But within those leaders within Japan and the US, it's really been the large-cap segments in the US and [00:04:00] Japan that have led. But that's really where the similarities end. I think there's an interesting story there.

Growth stocks have been the story in the US whereas interestingly it's been value that has been ascended in Japan. So let's just unpack that maybe one layer further. The growth story in the US, we know it's been the Magnificent Seven, the so-called super tech stocks that shifted of late.
(04:25):
I think the last time we were on this, I called out the crowding risks in [00:04:30] the so-called Super Seven Stocks and I have to maybe score myself a C- as we only got half for those correct. Four of those seven have pulled away, three have struggled since then. But a key risk, in our view, a key risk remains in US large-cap stocks. And that is are they still priced to perfection? So one of the comments we're hearing back from our own clients, and my colleague Dinant has done some work on this, is to [00:05:00] compare the forward earnings yield of US stocks versus, say, real bond yields. So that gives us some measure of the relative attraction between stocks and bonds. By that measure, US stocks are pricier than their international counterparts. So the story there is a downside risk in the US is a consideration for alligators.
(05:20):
Let me pivot to the other region that I mentioned, which is Japan, and I mentioned earlier, value stocks. First is what is value? How do we think about value? [00:05:30] So these might be firms that are cheap for a reason, they're cyclical, they have macrosensitivity, maybe they have subdued earnings outlooks. It's these very firms, the older established firms in Japan, Toyota, Mitsubishi that have led the rebound. And as you just note, I'll just close off this here, that it's not just been a story of a falling yen. I think the yen now is 150 to the dollar. It's not just the story of a falling yen driving exports, though that has helped. It's [00:06:00] something more fundamental. So one is there is a spillover effect from AI on Japanese semiconductors from the AI frenzy, but more importantly there is this shift in the operations that is the underlying profitability of those firms.

Ashley Lester (06:15):
Well, that raises all sorts of fascinating questions, including why the Magnificent Seven now seem to be just the Fab Four and whether there's any sort of strength of AI angle or some other angle that could help explain that. And then I [00:06:30] guess second would be do we have any sense at all on why it might be value stocks in particular that are doing well in Japan? One sort of famous fact for quant investors about Japanese equity markets is that of all the factors, historically value has tended to work the best. So is this just a reflection of the permanent state of affairs in Japan or is there something else going on?

Anil Rao (06:56):
Yeah, let me take the second question first, which is kind of why value [00:07:00] in Japan. I think one way to think about that question, Ashley, is just to kind of go back to fundamentals, what drives stocks return or market or portfolios return? And a very elegant formula that I've found is to think just in terms of what are the components of that. So the component of a stock return is due entirely due to its dividends, that it pays its top line growth, its bottom line growth, and some net buybacks. And then lastly, valuation [00:07:30] expansion. If we look at the two halves that I mentioned in Japan, growth stocks and value stocks, Japan is historically, and I know Laura will speak this, it's lagged developed markets, their firms in terms of capital efficiency that is profitability, whether we measure that's gross margin or net margin.
(07:47):
I think where I find the Japanese story particularly interesting is if we break the market into those two halves, value and growth, and then look at the drivers of returns just over the last 18 months and we decompose the returns, [00:08:00] what has driven Japanese value? Okay, there's been some multiple expansion, there's been some top line growth, but by far the largest driver, we can see this, we can quantify this, the largest driver, margin expansion, that is profitability of those firms that I mentioned, Mitsubishi, Toyota, these are old school think Japanese conglomerates, these are legacy Japanese firms. Their profitability ROE [00:08:30] has markedly gone up. So we can trace return due to that.

Ashley Lester (08:34):

That's pretty cool. So who would've thought of equity markets to reward companies that are becoming more profitable? I do suspect Laura might have a bit more to say about that, but I'll turn to Luis first because we at MSCI are in the fortunate position of not only possessing vast amounts of data about the world's public markets, but also some of the world's best data about private markets. Luis, while public equity [00:09:00] markets have been surging on, what's the state of play in private markets?

Luis O'Shea (09:05):
I think we see some of the similar themes that Anil was talking about. But maybe before I get into that, I should just say a little bit about the data I'm going to quote, just to put it in context, so I would describe it as private capital data. So more precisely these are closed end funds. So essentially think private equity, venture capital buyout, but it's a broader universe that includes [00:09:30] things like private credit, private real estate, real assets and various other sort of sundry, hard to classify portions of the private universe. The other thing that's worth saying about it is sort of the reporting nature of this data. So it's a little bit lagged, so I'm not going to be able to be quite as up to date as Anil. The current universe that we're looking at is currently the 2023 Q3. We'll be updating it to Q4 [00:10:00] in a matter of a few weeks, but that's what we have at the moment.
(10:03):
And then the other thing to bear in mind is that given that these are private markets, there's a second kind of lagging that needs to be taken into account in anything I quote here, which is that they're not marks based on transactions. So the result of this is that everything aside from the reporting lag I just mentioned, so we're, I'm going to talk about Q3, even the Q3 numbers are, in effect, should be thought of as [00:10:30] being partially influenced by Q2 and partially influenced to a lesser degree by Q1 and even a little bit before that as well. In any case, what we see is that in sympathy, the most recent quarter, which again is Q3 in this space, in sympathy with the listed equity markets, we've seen generally not great performance, let's say focusing on VC and buyout. So VC in Q3 was broadly [00:11:00] down, and I'll just leave it at that.
(11:01):
I'll come back to it in a little bit more in a moment. Although that could be related to the large cap, small cap distinction that that Anil was making. In the case of buyout, here, what we see is that this is kind of technically positive. I mean it was 1% roughly up in the US and Asia, it was about flat in Europe. But even that needs to be taken into account that there was a sort of a [00:11:30] few percentage points decline in the Euro and most European focused funds have US holdings. So I think taking that into account, sort of the true European, by the way, that was a Euro decline. So taking into account their US holdings, probably their Europe focused holdings performed negatively. So not sort of a great story there. I'd be interested to hear Anil comment on US versus Europe in a second.
(11:58):
But maybe more interesting is just [00:12:00] taking a slightly longer look and looking at what happened over the last year. So there in the case of buyout, US and global returns were eight or 9%, so not too bad, I would say. Not a great return for private capital, but not too bad. Europe was significantly less. It was 4.6%, but maybe the more interesting one here was Asia, which was 11.4. But here there's an interesting bifurcation. So if you break it out at China, China was way behind at [00:12:30] 4.2%, and then Japan. Now Japan is slightly tricky, we don't currently break out Japan separately in our universe, but as a quick proxy you can just sort of look at yen denominated funds, which effectively is likely to give you a similar answer. And this gives you a remarkable sort of 20, 25% return in the one year period ending in Q3. So this certainly aligns, I think with what Anil was saying about the performance [00:13:00] of Japan.

Ashley Lester (13:01):
Wow, that's amazing. And it was, so those patterns sound pretty similar to a, I would say very surprising degree really, to the price patterns that we see and return patterns that we see in public equity markets.

Luis O'Shea (13:16):
Although I would like to hear about Europe.

Anil Rao (13:18):
They do. I think Luis, the only comment I would add there is I mentioned the kind of large cap segment doing very well in the US, Japan, in Europe, the segment that's let's [00:13:30] say over the last trailing year, the segment as you mentioned, that's done the best, are European large caps, so think of that as their equivalent of the Magnificent Seven, Heyesemel, Novo, Nordisk. The one segment of the public equity market where large caps have done relatively poorly is in the emerging markets.

Luis O'Shea (13:49):
One final data point I want to mention is that if you look at the last year in venture capital, there things look even more pessimistic than more recently. So they're off by [00:14:00] 8.7% in the US, -11% in Europe, -12%. So I wonder if that reflects the weakness in small cap or micro cap conceivably as opposed to large cap.

Ashley Lester (14:15):
Wow. So it sounds like a lot of froth may have been blown out of the market. Now I want to come back though to, you've both highlighted Japan, it's very unusual for those of us below a pretty significant age in markets [00:14:30] to be talking in an excited tone about returns in Japanese markets and at least on the public side. And you already highlighted the effect of an apparent spike in profitability coming of all places from the largest and most established and perhaps even traditional Japanese firms. That sounds kind of surprising on the face of it. Laura, do you have any insights that you can bring to this from your [00:15:00] perspective?

Laura Nishikawa (15:01):
Yeah, for sure. And so to give a bit of background, I think many of the listeners might know, but Japan has been on a decades long path of corporate governance reform, really spearheaded by former prime minister Abe through the Japan Stewardship code, which came out in 2014 and the corporate Governance code, which came out in 2015. And the idea or motivation or the promise behind this was always that by making companies more accountable to their shareholders, we prompt more [00:15:30] efficient capital management and more profitability and thereby an economic revival of Japan. That was the whole, one of the three pillars of Abenomics. And so what we've found when we look at the data is that while Japan is still lagging, a lot of the develop market peers, it is the most improved country in terms of our corporate governance ratings, in terms of individual indicators that we look at.
(15:52):
So in our corporate governance rating, we look at a number of factors across board, board independence, board leadership, board effectiveness, ownership [00:16:00] control, compensation, et cetera. And on those measures, Japan really is the top performing or top improver of the last five years. What we've seen is that companies have been slowly adapting to the code. You can most visibly see that in the improvements and gradual and painful improvements in board independence, buying back some of the cross shareholdings, some of these reforms that have happened. But you've also [00:16:30] seen investors in Japan domestically taking a different tack. And we've seen that really behind the scenes when we work with these companies, when we work with these investors. But the data also bears it out. So for example, a really big headline for us is just the percentage of companies that face significant negative votes on directors. Once upon a time it was unheard of to vote against a slate of directors in Japan, and now we see upwards of 40% of companies actually getting negative votes on these directors.
(16:58):
So there is a significant change [00:17:00] happening, and that seems to be paying off in terms of companies, capital management, their capital efficiency, their profitability, especially with some of these larger, more established companies, which seems to be slowly paying off in terms of returns as well. One of the things that I find really interesting about this from kind of the sustainable investment lens is that we often talk about ESG and sustainability and picking winners and losers within a sector within a market, and this actually [00:17:30] showcases how a lot of our asset owner clients think about deploying sustainability and sustainable investing, which is really lifting up the entire market. And this seems to be a case that has started to pay off.

Ashley Lester (17:42):
Laura, that's fascinating. One of the things which let down at me about your description of these matters was the whole focus of your discussion was on a transmission mechanism from corporate governance through to profitability and therefore to companies generating returns [00:18:00] for shareholders.

Laura Nishikawa (18:02):
Yeah. I think there's a lot of misperceptions around sustainable investing, and I don't have time here to go into all of them, but there in particular have been a lot of misperceptions, especially in the last two years, around performance and sustainable investing and what really is meant and what sustainable investing is able to achieve in terms of improving how investors can identify more profitable and higher returning investments. So there's been [00:18:30] a lot of noise about underperformance of some ESG and some sustainable funds in 2022 because they were underweight energy, which was not a good time to be that, there was obviously outperformance of those same funds in 2023, which were overweight tech. I think that gets a lot of the headlines, that and talk about those fund flows, but I really believe that that does not represent how the vast majority of investors and the vast majority of our clients think about ESG.
(19:00):
[00:19:00] So we updated our research just very recently in the last month on looking at our track record, we have a 17 year track record of ESG ratings which are focused on the most material risks and opportunities the companies face and how they're managing those relative to other companies in those same sectors. And what we found is that the thesis that we've put out at the beginning, the kind of landmark research we put out five years ago, the findings still hold, which is that the top quintile of ESG rated companies still [00:19:30] outperform the bottom quintile of ESG rated companies across regions, across time, not by an enormous margin, but by a significant one even when you control for sector for size for region. And that going back to what Anil was talking about and your surprise, Ashley, that more profitable companies can actually be rewarded, we do see that the transmission channel of that is not higher valuations for top rated stocks.
(19:56):
It's actually more profitable companies, higher dividend yields, [00:20:00] better earnings quality and more profitability. And so what we're talking about when we look at ESG is not necessarily tech versus energy. What we see is that actually the top rated energy stocks outperform the bottom rated energy stocks in Europe. We see the top rated tech stocks in the US outperform the bottom rated tech stocks in the US. So we're talking about something much, much richer. And I think the next phase of this research is really to dig underneath the hood because it's one thing to talk [00:20:30] about ESG, I think that acronym has everybody just a little bit either confused or frustrated or both. But can we actually dig deeper into is it the E, is it the S, is it the G? In what markets, in what context, in what industries? What's driving this continued long-term outperformance that we see?

Ashley Lester (20:47):
So I think there's two areas in particular that I want to dig into from what you're saying. One is that there might be better targeted ways of thinking about whether ESG as a concept can [00:21:00] help deliver better risk and return payoffs for investors than just looking at some of the indexes. And you mentioned as a possible test for instance, looking at top quintiles versus bottom quintiles within industry and so on. And I think it might be worth just spelling out for our listeners why that's so much of a better test. And then second, so we've talked about G and why better G might actually be expected to be associated [00:21:30] with companies that are behaving better, more in the interest of their shareholders and therefore over time delivering broadly better returns for shareholders. But what about S? Society and social and all that stuff, that seems a lot harder to be relevant to shareholder concerns, right?

Laura Nishikawa (21:49):
Yeah, just on the first question, just analytically, what we're trying to do is isolate the impact of ES and G and the factors that we're looking at relative to other factors. We don't want to [00:22:00] claim that ESG called a

major rotation in other factors or something. We really want to just be intellectually honest about the conclusions that we draw on. We're not activists over here at MSCI. We don't have an agenda. We are trying to understand the data and understand what the data can help to tell investors. So we're really trying to look at this as clearly and honestly as possible, which means doing these kinds of robustness checks as well. We look at quintiles, we look at terciles, we look at halves, we look across [00:22:30] regions, across sectors, and a lot of that research is available and published, some of which is, we also have a wide range of academics using the same data to see if their conclusions cross check with ours. On the E versus the S versus the G, so there's been a lot of talk for many years that it's all about that G.

(22:50):
G is the factor that I think most fundamental analysts most automatically kind of relate to, especially when it comes to topics like capital efficiency that we talked about. We did [00:23:00] see for many years. And in some markets, the G really dominate the kind of ESG in terms of correlations with performance. What's really interesting is across all of the markets we look at, actually the aggregate ESG does better than any of the individual pillars, but of the individual pillars, G was really leading, I would say globally probably up to 2020, G was the strongest factor. Post 2020 in APAC, we still see G being very, very strong. But globally speaking, what has not only overtaken [00:23:30] G in the last three years, but actually overtaken G over the last 17 years is the S. And I think that's very, very confusing to people, especially in this time where the S can be very misunderstood and very polarized.

(23:44):
So I just want to clarify, I'm really excited to get away from the ESG acronym a little bit because I think these descriptors are not very evocative of what we're measuring. I think a lot of people hear S and they think investing with a social agenda, and that is absolutely by far not what we talk about [00:24:00] when we talk about S. What we're talking about in MSCI when we define social risks and opportunities are how companies are managing those material strategic and operational risks associated with their workforces, associated with their customers, associated with broader stakeholders. So what does that mean? We look at how companies are attracting talent and retaining talent, how they're managing large and complex workforces in an environment of more automation and very rapid technological advance. You don't need to be [00:24:30] kind of socially minded. That's just core strategic business management for companies.

(24:36):
We're looking at how companies manage the integrity of their supply chains. That's been something that's been a huge topic for many industries and for markets, especially since COVID, but even more recently with increasing disruptions in the supply chains, how are companies managing that? We look at how companies are managing privacy risks and the run-up of AI, a critical consideration for boards for management in [00:25:00] this environment. And we look at very basic bread and butter issues like product safety, if the door flies off of the airplane that you're on, that is then S issue in terms of how we measure it and how companies are managing and governing that. So I'm not surprised that the S is doing well. I think most people are, and I think it's really important for us now to just maybe get away from the S label and go into those underlying topics, those underlying themes.

Ashley Lester (25:28):
Thank you, Laura. That's been an extremely [00:25:30] enlightening conversation for me and hopefully for our listeners. So I guess we should complete our tour, much as you want to get away from the ESG label. We've talked a bit about S and a bit about G, so we might as well finish up with the environment and obviously a huge component of the environment is climate, but by applying our ESG lens to climate investments, what can we learn about the ways in which climate investments are being directed by asset managers and others [00:26:00] towards a transition or a lower carbon economy?

Laura Nishikawa (26:03):
Yeah, this is a really interesting question and something that's evolving very, very quickly. We see huge amounts of capital being deployed towards climate strategies, climate funds, climate solutions, not as much as

maybe some might like from a policy perspective, but it's really significant how investors are gearing up. But what that means looks different. There are a lot of different ways to invest in climate [00:26:30] and also what we've seen most recently, and I'd love to get Luis's take on this, is a very big difference in terms of how climate strategies and climate funds look between public and private markets. So in public markets you tend to see, as I said, overweight tech, underweight energy, these kind of tilts towards lower emitting sectors, lower emitting companies, that's maybe kind of first generation gen one of climate investing. What we see in public markets in terms of [00:27:00] discussion not yet flows is a conversation around putting the money where the emissions are.

(27:05):

So not just investing in the lower emitting stocks or the lower emitting sectors, but actually investing in the higher emitting ones that are transforming, that are transitioning, that are inventing new technologies, that are investing in those new technologies. And I think what we've seen is that that's actually borne out in private markets because when you switch over to looking at climate labeled private funds, you see a very different sector [00:27:30] mix. One that is actually much more aligned to that transition mentality of sectors that are deeply in the weeds of the energy transition and not just happen to be lower carbon based on their business activities. But Luis, I'm curious if you had anything to add to that.

Luis O'Shea (27:47):

Yeah, that's exactly right. There's a nice phrase that somebody used which is the difference between sort of reducing financed emissions versus financing reduced emissions. So in other words, [00:28:00] are we trying to simply avoid emissions, which is, you could almost say is kind of like an allocation question, which seems to be closer to what we see in sort of public climate focused funds. In contrast in private funds, again, private focused private funds, we see exactly what you were saying, which is not shying away from the more carbon intensive industries, but instead embracing them and presumably [00:28:30] there's, this is more difficult evidence to collect, but presumably improving or reducing their carbon intensity, I suppose. So just as a random example, by NAV, the fraction of renewables amongst climate focused private funds is around 41%, which is a sort of a stark contrast to the public funds. But I also want to just go back to a point that you made earlier, well, [00:29:00] both Ashley and Laura made, about the fact that remarkably returns are of interest here.

(29:08):

And something else is kind of interesting here is well, if you look at least private funds, how do they look for a return perspective? What's interesting is, say we compare renewables with oil and gas and we look again at private focused funds, what we can see is that the renewables have actually outperformed. And here, by the way, [00:29:30] measure of performance I'm using are multiples as the ratio of cash out to cash in, the renewables have outperformed oil and gas every year since 2016 in our universe with one exception, with the exception of 2018. And then the other thing is just almost a matter of scale. If you look at how these two subsets oil and gas versus renewables are moving, there's, for the last, approximately the same time range, what [00:30:00] we've seen is a flip where the number of investments into renewables have exceeded the number of exits. And this is again in contrast to oil and gas, which over roughly that period exit seems to be sort of exceeding investments. So there seems to be sort of a clear kind of inflection where there's a greater interest in some of these industries in private funds, climate-focused private funds, both from a return perspective and from almost a [00:30:30] sort of capturing a portion of the market perspective. It seems that private funds are relevant and in particular, renewables are important.

Ashley Lester (30:39):

That's actually really fascinating because Anil, I mean my sense would not be that that would be nearly as true in public markets over the same period where I suspect energy companies have probably done well have they, there's probably a lot less market cap in renewables. Is that fair?

Anil Rao (30:59):

Yeah, that's right. [00:31:00] I think year to date, from what I checked this morning, energy is the top performing sector. If I could just maybe have a comment and a hush infer, Luis and Laura, one of the things that's been on my mind and I think on our client's minds as well, is that we look at one small segment or not so small segment of the energy transition opportunity set, and that is the electric vehicle segment. Those firms, the stocks of those firms have really struggled with [00:31:30] headline by Tesla of course, but it really stretches down the cap. Rivian, Fisker, some of this is a, as you mentioned Luis, it's a challenge IPO in US small cap market, but my understanding is the unit economics of those firms, profitability of selling an electric vehicle is just very challenging. They get sold at a loss. But I think one of the pieces of work, Laura, that your team is doing that's really fascinating is to just look beyond [00:32:00] the electric vehicle space and look at the full opportunities that the entire energy transition, almost like rate every single firm in terms of its exposure, its sensitivity to the transition opportunity, it goes well beyond electric vehicles, and it stretches into some of the things that Luis mentioned, which is power generation.
(32:18):
So that's just, I'd say that's a comment, but it's also just a question of how to think about that.

Laura Nishikawa (32:25):
Yeah, I'll answer that, and then I also had a question for Luis that we can go in a big [00:32:30] circle. I think you're right there, and I think when we talk about some of these opportunities, Ashley, you mentioned the smaller market cap of renewables, and I know you mentioned some of the short-term bumps faced by the EV sector. You can give these climate solutions and transition finance kind of a bad rap, right? We're talking about very small sample sizes, very small numbers of companies over short periods of time. So a lot of investors in public markets, especially that we're talking [00:33:00] to, really want a more diversified opportunity set to capture the broader shifts happening in the climate transition. What's the full value chain of those EVs? What are perhaps the maybe less overvalued names within that are not headline climate solution, renewable solution type providers, maybe some of the more boring value stocks that have exposure to that theme of transition?
(33:24):
So we're working right now on a kind of technology-led approach [00:33:30] to identifying what companies are investing in, what technologies across the value chain and how can we bring out maybe a broader opportunity set for investors that want to capture exposure to this transition, but not necessarily a concentrated exposure into the same small basket of names that everyone is in. A lot of that is a work in progress, a lot of it is really reliant on data. Do we have enough data on companies capital expenditures and their patents and we're gathering as much as we can [00:34:00] and it's coming up, but maybe going back to private markets, that availability of data to even make these investments or label them as such or have a credible climate strategy is still emerging and an area that we're obviously very, very keen on, which is what data can we get to identify these opportunity sets to measure how they perform to measure their characteristics?
(34:23):
But I think it's interesting, and in private markets, if you talk to the climate-minded investor, maybe five years ago, they would've said, "Oh, that's [00:34:30] where all the fossil fuels go to die," that it's opaque, it's unclear, we don't know what's in there. And I feel like that tide has shifted and you see that with some of the flows and the new products, which is that private markets are actually now being seen as absolutely critical to funding the transition, but also capitalizing on the opportunities associated with the transition. So I don't know if Luis, you've seen that shift in mindset. I still have from my seat, but [00:35:00] yeah, curious if you see that.

Luis O'Shea (35:01):
Yeah, I think I've got a couple of comments about that. So first of all, I think you are right or the way that I would characterize this kind of question of whether private funds are a place to hide dirty industries or dirty companies, I think that certainly that's received a lot of attention. I'd say there's maybe mixed evidence on that front, and I think part of the reason there is that the data is not quite what we would like it to be. So to some extent there's a [00:35:30] certain amount of averaging over, say, the last five years, and there have been

significant changes over the last five years. So that's sort of a further, obscures the answer. Certainly it's the case that, I forget the fraction right now, but sort of an enormous fraction of all climate focused private funds have been raised in the last three or four years, which is kind of remarkable.
(35:55):
And then finally, returning back to data, this actually is a very important point because [00:36:00] while we would love to have perfect data on this, and that doesn't exist even in public markets, it's even more true in private markets. So just to give a sense of scale amongst our universe, amongst the entities, the portfolio companies in our universe, what we see is that the number of companies, what funds, and therefore companies that report scope one and scope two, for example, is around 2.2% of our [00:36:30] universe. And actually it's 1.7% amongst private debt and private equity funds. So excluding infrastructure and various other sundry pieces. And the same would apply going back to some of the other sort of ESG variables that Laura was talking about earlier. So at the moment, gathering this kind of data is a sort of real challenge.

Ashley Lester (36:50):
Well, where data fears to tread, anecdote can definitely step in. And I'm privileged in my job to go and speak to senior [00:37:00] investment professionals at many of the world's largest pools of institutional capital, largest and most sophisticated pools of institutional capital, whether those are in North America or in Europe and EMEA or indeed in APAC. And perhaps there's no coincidence that the investors who are largest and most sophisticated and in many cases have among the largest allocations to private [00:37:30] assets, private equity certainly and perhaps increasingly private credit, are also amongst the investors who are most focused on the transition to a green economy. And the striking number, which our listeners need to be aware of, is that in order for us to transition successfully over some sort of reasonable horizon, the world needs to be looking at spending well over $2 trillion a year for 10 to 15 years each and every year.
(37:59):
And [00:38:00] that's an enormous number and enormous number can stop meaning anything. The Inflation Reduction Act was about 850 billion. So the world needs to be spending about two and a half or more IRAs every single year for 10 or 15 years to finance the transition. That money has to come from somewhere and it's going to, I guess partly come from these very large fist headed pools of capital. And also there are going to be people who make money off that spending, their [00:38:30] companies are going to be well-placed to provide the infrastructure or the minerals or whatever it is that's needed. And so this is an opportunity to both finance the transition and generate returns out of capital. But these are huge flows and as we've mentioned, there's probably not enough capacity maybe in public markets to sustain the flows and to generate the transition that's needed and hence the focus on private markets from these big institutional investors. It's possible in fact that private debt might be a big [00:39:00] way in which the transition gets financed. What can we say about the flows of money into or out of private equity and private credit over recent years in general and particularly more recently?

Luis O'Shea (39:14):
So if we look at what we call capitalization, so essentially the total amount of capital raised in private capital and then you segment it by private credit, private debt, there's been, certainly, it's sort of widely known that private [00:39:30] credit has seen tremendous expansion, especially since after the GFC. Maybe one interesting little sort of caveat I would put there is that that is true, but all of private capital has also seen sort of tremendous expansion and indeed even public markets as well. So a fair comparison I think might be to sort of look at how private credit has expanded relative to, say, private equity. And if you look at it through that lens, [00:40:00] then what I think is essentially the story is that there was a tremendous expansion post GFC in private credit relative to private equity. Since then, it has been far more steady. So I think maybe it's possible to sort of overplay a little bit this expansion of private credit, at least as seen through closed-end funds. And I think that maybe an additional sort of nuance here is that we're seeing also a diversification the kind of vehicle [00:40:30] types and the appearance of more, for example, open-ended vehicles, especially in private credit.

Ashley Lester (40:36):
And those open-ended vehicles, just to the, perhaps we can tease some future issue of the podcast if we don't have time to get into it now. But open-ended vehicles I guess are being lodged here because private asset managers want to access new pools of capital that perhaps they can't access at the moment, wealth springs to mind. [00:41:00] And those types of pools of capital aren't prepared to lock up their capital for the 10 or 12 or 14 year period that traditional private investors need to be locked up for. But the obvious question here is if you can access private capital more or less at any stage and without being a qualified or institutional investor, what's the difference between private and public capital in that world?

Luis O'Shea (41:27):
Fair enough. That, I suppose, is a somewhat [00:41:30] provocative question. It's fair to say that there does seem to be a sort of a general interest from retail and wealth in increasing, we could call, liquidity in general in private capital, but I think it's also fair to point out that there's at least one other sort of pressure forcing this change, which is, Anil mentioned it a little bit earlier, which is sort of the poor state of the IPO market at least maybe until recently. So distributions [00:42:00] within private capital have been down for the last sort of year or two. This has been somewhat true amongst buyout funds. It's been very, very much true, not surprisingly, given my IPO comments amongst venture capital firms. So I think this has been another reason why there's been a sort of an interest in more flexible fund types, as well as, of course, the interest in something that isn't quite the same but relevant to liquidity, which [00:42:30] is the increasing interest in secondary transactions.

Ashley Lester (42:35):
Well, I think we could go on talking for much longer. Our time today is drawing to a close. Thank you very much Anil, Laura and Luis for joining us today. And thank you to our listeners and we hope you'll join us again in a quarter's time.

Adam Bass (42:52):
That's all for this week. Many thanks from Joe and me to Ashley for taking the mic and to Anil, Luis [00:43:00] and Laura for sharing their insights. And as always, to all of you for listening, you can find more of MSCI's quarterly insights on the In Focus page at MSCI.com. You'll also find the link at the bottom of this episode page. We'll be back in two weeks with a new episode of Insights for Institutional Investors. Until then, I'm your host Adam Bass, and this is MSCI Perspectives.

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