Investment Horizons

Fall 2020

Research insights at Schroders

- Navigating #TheZero
- Why Corporate culture matters
- Why a Corporation's "cost" on society matters, too
- ESG and green bonds
- Understanding China's QFLP program

Schroders

Perspectives on transition

We are pleased to provide our 13th edition of Investment Horizons, our North American perennial compilation of research articles inspired by our global client engagements.

In this, our year-end edition of what has been arguably one of the most interesting starts to any decade ever, we look at transitions across the asset management world.

Perhaps one of the most pronounced transitions was the response to the pandemic, resulting in zero interest rates here in the US. As one of the last bastions of yield in the developed markets, many wonder where do investors go from here? Our Head of Securitized Credit, Michelle Russell-Dowe, explains why the “road less traveled” may offer clues in the search for yield, without a dramatic increase in risk.

Our next two articles focus on the Corporate universe. The first article is on culture and why it matters not just to engage with companies on such issues, but to do so intelligently. The second paper looks at how important it is to understand the cost (or benefit) that a company or sector has on society – and why it’s critical to go beyond the theoretical. In both cases, the transition from companies being beholden only to their stockholders is becoming a thing of the past as there are many stakeholders in today’s corporate ownership framework.

Our penultimate article looks at a grass-roots asset class – green bonds. Our Head of Sustainable Credit Saida Eggerstedt sits down and provides a Q&A on the market’s transition to green bonds, what investors need to know as they near the $1 trillion milestone, as well as the emergence of “social bonds.”

Finally, China’s presence in the market continues to reach new heights. The private markets are no exception, and the RMB universe will undoubtedly gain more attention in the decade ahead. As we outline in this research piece, access to the right structure and having local expertise is critical for foreign institutions.

As always, we hope you enjoy reading this edition, and if there are any other topics of interest to you please contact your Schroders representative.

Contents

#TheZero

Zero is both a number and a concept and as such, **Zero** is critically important. But as **Zero**, the number, becomes more associated with benchmark interest rates and returns on bonds, its importance cannot be understated. At the beginning of what could be a prolonged period of policy-fueled financial repression, we will all have to focus on **Zero**, its impact on investment decision making, and its impact on asset allocations. We have only begun to see **Zeros** everywhere.

At its most basic level, **Zero** is the absence of anything; that absence can be a hard concept to explain. Most simply, the absence of things can be taught to children, much in the same way I taught it to my brother when I took all his toys away. Perhaps he would see it as poetic justice that the concept of taking away, until nothing remains, is my focus here. Today, #TheZero means simply this, that nothing is left.

Michelle Russell-Dowe
Head of Securitized Credit

Nicholas Pont
Investment Director, Schroders

The CIRCLE of life

The absence of income manifests with Zero Interest Rate Policy (ZIRP), when benchmark yields approach Zero. In this instance, the basic 60/40 investment portfolio strategy seems to inspire more questions than answers. Can we achieve a balance between growth and safety? Will bonds any longer offset equity volatility? How do we earn income? If the base return is Zero, or negative, are we still looking for alpha? Or, do we need to now re-examine the risks that we take on in order to earn that alpha. Indeed, should we revisit the merits of exposures to certain asset classes and their current efficacy as return generators? Clearly, there is some basic math to reconsider, not just at the fundamental level, but at the investment allocation level, and at the life planning level. #TheZero has material implications for how we live our lives, not just for our investments.

Add the Zeros to the end through hard work

I've always liked simple concepts. The simple plan: work hard, get a scholarship, educate yourself, get a job, care for your loved ones, save money, invest, retire and live off of the income your invested savings generate. Invested savings, as a simple rule, meant bonds. Using bonds was the plan because you could earn income and maintain your principal. Simple plan, ironclad… or so I thought.

What happens when simple becomes complicated? What happens when the coupon income generated by bonds is close to Zero?

With Zero income, the math no longer works for retirees, not to mention for those that manage pension plans for the benefit of retirees. Furthermore, in a demographically top-heavy society, this problematic paradigm is compounded. If savings do not generate adequate income, you have three options: you must be willing to spend down your savings, you must be willing to reduce your expenses, or you must continue working for a longer period prior to retiring. This reality is becoming more common and I've seen a new acronym to represent it, "D.A.D.", which stands for "Die At Desk".

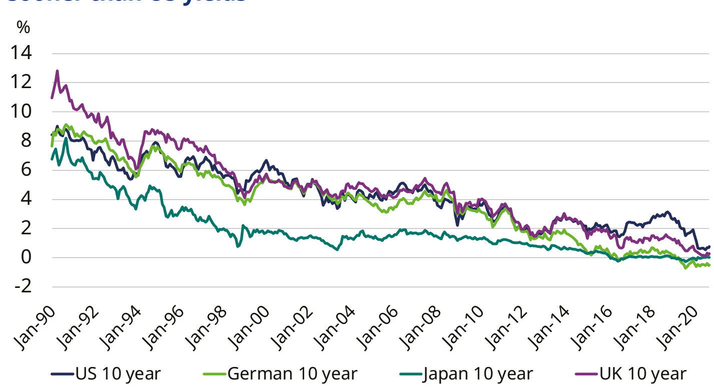
This is the impact of "The Zero", and it will get a lot of attention, it certainly has ours (or mine). Macabre? Yes. Escapable? Definitely.

How we got to Zero

Interest rates for developed countries have been structurally declining. Globalization, low levels of inflation or even deflation, and lower growth rates have all contributed to the multi-decade decline.

Japan, in the 1990s, was the first near-Zero interest rate regime. In 2014, Europe joined Japan, as local rates went beyond Zero into a negative interest rate regime. It is worth noting, in both cases, investment capital flowed to countries with higher structural interest rates, notably the US.

Figure 1: Non-US yields found their way to the bottom much sooner than US yields



Source: Bloomberg, 10/19/2020. Yields fluctuate over time.

In the US, policy action has resulted in short-term interest rates near Zero, notably during the Global Financial Crisis (GFC). But today, the yield curve is flatter, so it is not only short-term rates that are near Zero.

Central banks are the buyer of last resort, not only for sovereign debt, but now for other corporate debt as well. With little additional yield available for longer term investments (term premium), the search for "any" yield has led to increased demand for more traditional "risk assets", with a commensurate reduction in credit risk premium for most "run-of-the-mill" fixed income instruments. Facetiously we ask, should we call it fixed "income", or is it now just "fixed principal".

The jokes like that are adding up, and they're becoming increasingly less funny. How many times in the last few years have you looked at the term "high yield", scoffed at it, and thought, "more like medium yield".

So we agree The Zero is not new… we have seen near-Zero interest rates in Japan as well as in Europe. However, when those local rates declined the US represented a haven of sorts, the higher yielding developed economy… that is not so anymore. We believe with current market dynamics will now write this in neon, 'blink, blink, blinkity blink'.

Figure 2: US yields have found their way to the bottom, too

Source: Bloomberg, 10/19/2020. Yields fluctuate over time.

The Federal Reserve (Fed) first ventured to ZIRP in December 2008 and it held the Fed funds rate near Zero through December 2015. What is the difference now?

Time, for one, and the flatness of the yield curve, for another. We tend to forget that the term structure of the yield curve offers the markets opinion of the future for interest rates. The flatness of the yield curve today is potentially pointing to a prolonged period of low interest rates.

Low discount rates have also resulted in appreciation of assets, both real and financial. Cheap leverage is available in the government-supported debt markets. So there seems a disconnect between the economy and, valuations, spreads and leverage.

There have been three principal boosters that have propelled markets forward from a valuation perspective (and pushed yields lower), and their combination makes the prospects for generating income and return more challenging. Namely:

1. Monetary support
2. Fiscal support
3. Perceptions around recovery

Today, the world we sit in feels very uncertain. Even with this uncertainty, it seems compensation for risk is unusually low. Policy dependence has brought us here, and with very little yield in traditional fixed income, with crowding in traditional "risk assets" like equity, and with correlations pulling together, traditional asset allocations may be in for a reconsideration.

Zero begets Zero?

#TheZero feels like it's here to stay. With that, what should not go unappreciated is the impact low rates and low income may have on consumer behavior and, therefore, economic fundamentals.

Let's take D.A.D., "Die At Desk", as an example. If investment income is insufficient to support a retiree, a potential retiree must continue to work, likely past the retirement age assumed. The potential extension of working years has significant consequences for the labor pool.

If everyone must work forever, we have an infinitely expanding pool of labor. Say it again, "infinitely expanding labor pool". It surely makes it difficult to imagine wage inflation, and limited inflation means lower interest rates for longer.

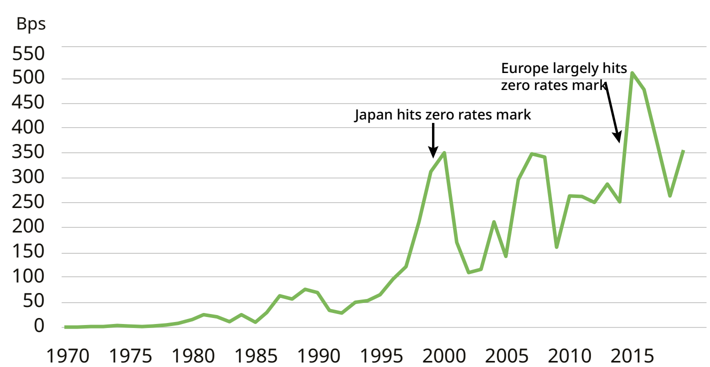
Zero may be spelled the same in many languages, but not in all of them

The impact of interest rates falling to Zero in the US may be broader in scope than what has been seen for other markets. The US is not the same. There are two important issues as Zero comes to the US.

1 **The US is big.** When other countries have seen their local interest rates depressed, the US often became the harbor for foreign capital flows. The US was the recipient of foreign capital flows when Japan (1999) and when Europe (2014) went to Zero or negative interest rates. At times, the US has been referred to as "the higher yielding developed economy". To be sure the US is a large country with a lot of debt, including government debt and corporate debt and, as such, foreign capital had a place to flow, even on a currency unhedged basis. The World Bank captures this in Foreign Direct Investment figures and we see spikes when Japan went to Zero rates in 1999 and when Europe went to Zero rates in 2014.

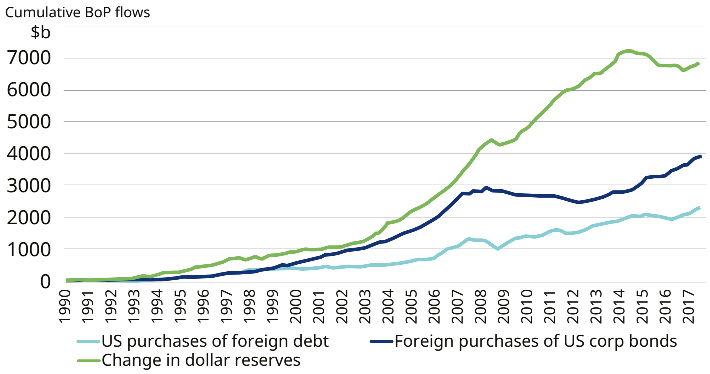
So, we ask, now with the US now joining the Zero rate party, where does capital flow?

Figure 3: Capital has routinely flown into US capital markets as the world goes to Zero rates. Will it continue?



Source: World Bank Group, through 2019. Reflects foreign direct investment (in $) net inflows into the US.

Figure 4: Corporate bond inflows versus US purchases of foreign bonds, mostly corporates



Source: IMF, BEA, Haver Analytics, 2020.

The increase in foreign purchases of US corporate debt, coinciding with Europe's negative interest rate policy implementation in 2014, has also been a factor in the reduced credit risk premium for corporate securities.

2 **The US has a larger population,** and retirement implications are different than other countries that have adopted Zero or negative interest rate policy. The social safety nets and retirement provisions in the US today are less than most European countries.

From the OECD data on public pension spending as of 2015, we see pension spend as a % of GDP: France 13.9%, Italy 16.2%, Finland 11.4%, Spain 11.0%, Germany 10%. By comparison, Japan is 9.4%, and the US is only 7%. As well, data on poverty rates for the elderly, from the OECD, show the US at 21%, versus the UK at 14% and European countries generally between 4% and 9%. The structure of our retirement benefits illustrates the importance, in the US, of earning income on savings.

You can add Zero to anything and not change it

If the impact of Zero on income is material, let's look at the change in bond maths!

Typical return generators for bonds are:

1. Duration
2. Roll-down
3. Coupon
4. Yield Spread

Duration return has dominated returns from a contribution perspective in recent periods and, in fact, has been a huge return contribution over the past four decades. As interest rates have progressively declined, fixed income has produced attractive returns. From where we are today, it is much less likely duration will be a material return driver, and it is worth the time to look at excess returns by sector, how those have evolved through different cycles, as you consider your drivers of return.

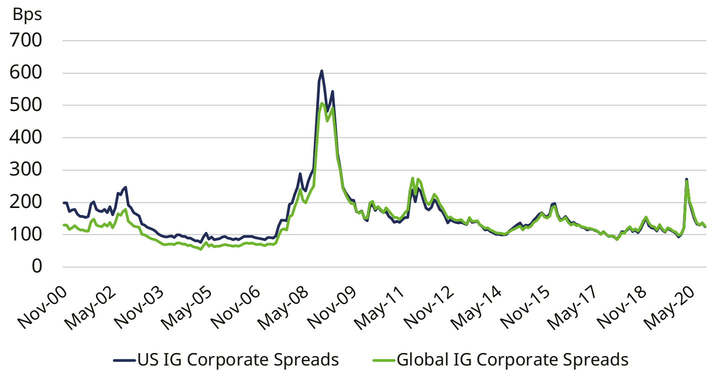
Roll-down is the concept that if the yield curve is positively sloped, a bond's price can increase as it shortens. Currently the yield curve is very flat, so roll-down will contribute much less to a bond's return. Notably, amortizing bonds receive less benefit for roll-down when the yield curve is steep, and they may be more attractive in a flat yield curve environment.

Coupon A bond, priced at par, earns its returns from coupon income. Today those coupons are lower given the 1-yr Treasury yields 15 basis points (bps). The coupon will be determined by the level of yield spread, which is also low.

Yield Spread is the risk premium added to the benchmark rate, to establish a bond's coupon.

Each of these sources of return has been material over the past four decades, and each is likely to be far less material going forward, a bit reminiscent of the disclaimer, "past results are not indicative of future performance."

Figure 5: Despite Covid-19, yield spreads currently remain near historical low levels



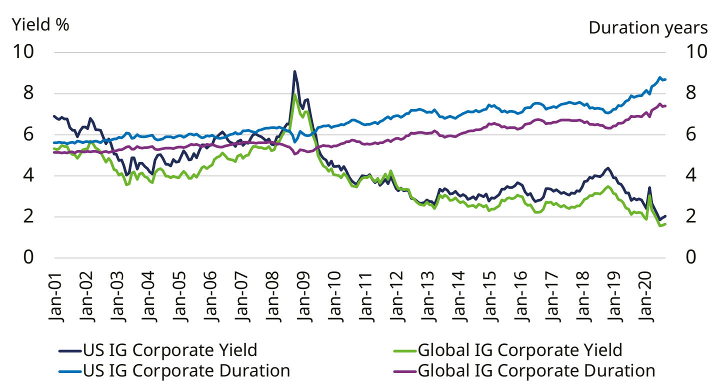
Source: Bloomberg, 10/19/2020.

Zero cushion?

Many investors in bonds have looked at carry and the cushion it provides against volatility or spread widening. The concept is this: the yield (or carry) a bond generates provides return, but also typically provides enough return so that it can offset some widening in yield spread.

Today, yields are very low, and duration has extended materially for corporate debt. With this as a backdrop, the traditional relationship between yield (or carry) and duration is no longer what we are seeing. The cushion carry offers to spread widening is now very low, and with higher duration, the impact, or sensitivity, to yield spread widening is, at the same time, much higher.

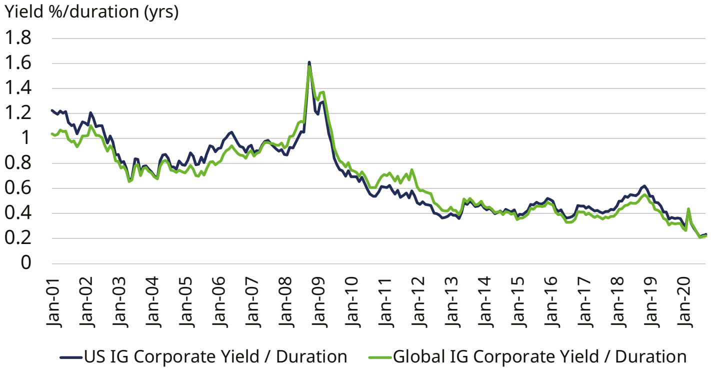
Figure 6: Today's bond math has become greatly skewed given much lower yields and much higher duration



Source: Bloomberg, 10/19/2020. Based on IG corporates indices yield versus duration. Yields fluctuate over time.

Looking back to the early part of the 2000s, investment grade (IG) corporate securities had enough coupon income they could sustain more than 100bps of spread widening and still break even to a Zero percent return. Figure 7 offers a simple measure of the yield, divided by the duration. A yield of 6% for example, divided by a duration of 6 years, would result in a yield/duration of 1%, or 100bps. This is similar to what we saw in the early 2000s. Post GFC, the yield/duration metric increased to 160bps; what a value! Since 2013, the yield/duration declined to 40bps and today it is only 20bps. With yields around 1.5%, and duration near 7.5 years, a 0% return break-even occurs after yield spread widening of only 20bps.

Figure 7: Yield-to-duration ratios have also found their way to Zero



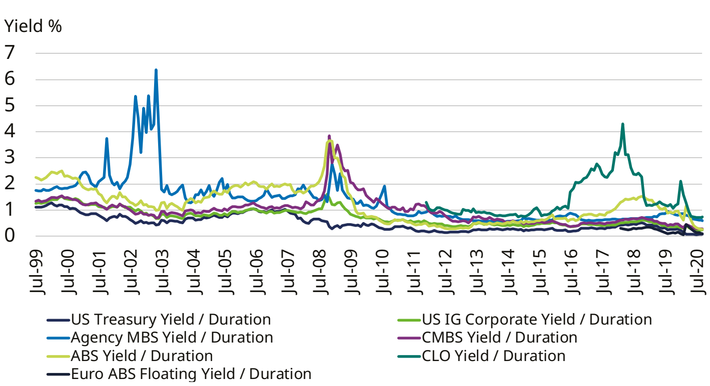
Source: Bloomberg, 10/19/2020. Yields fluctuate over time.

From Zero to Hero

With traditional yield metrics and return cushion alike, declining, where can attractive return be found? In our view, returns should be married to their risk premium, and the compensation for risk factors can range over time. Some examples are thus:

1. **Maturity risk premium** – today this premium is near Zero. US Treasuries (long versus short) are guaranteed, but do come with maturity risk
2. **Credit risk premium** – with everyone flocking to the traditional risk assets, these risk premiums have declined, even with considerable economic uncertainty. Corporate credit IG and high yield are traditional credit risk assets
3. **Sovereign risk premium** – country credit risk. Emerging market versus developed countries would showcase this risk premium
4. **Convexity risk premium** – guaranteed US Agency MBS, versus US Treasury notes would be a way to examine this premium
5. **Complexity risk premium** – structured product versus treasuries or versus corporate credit can be compared
6. **Liquidity risk premium** – being able to hold and compare public versus private assets

Figure 8: Fixed income risk and return premium change over time, leading to opportunity

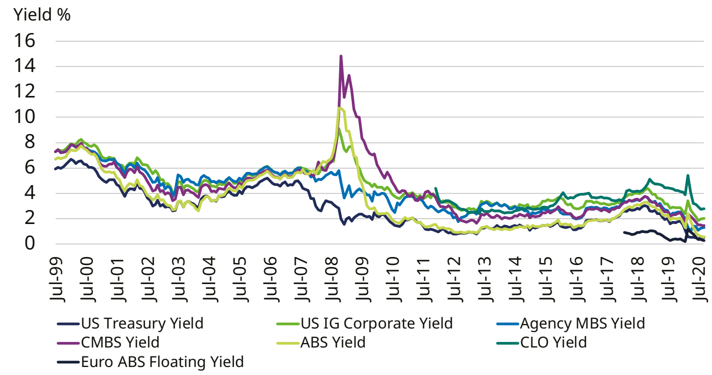


Source: Bloomberg, 10/19/2020. Yields fluctuate over time.

Presently, we see better carry/duration metrics coming from areas such as ABS, CLO and CMBS, rather than the common credit benchmarks (IG credit). For example, today the European ABS index offers more attractive metrics relative to US IG credit than at any point in the last three years, implying that the premium for the complexity is more attractively priced today. This is the benefit of off benchmark assets, or in the words of the poet Robert Frost, "the road less traveled".

When looking at yield alone, it is observable that the risk premia, for most traditional assets, have been reduced the most expeditiously in the search for yield.

Figure 9: Relative comparison across risk premiums of yield



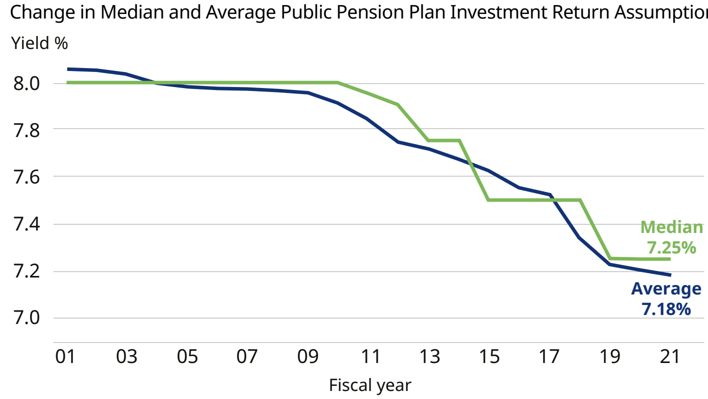
Source: Bloomberg, 10/19/2020. Yields fluctuate over time.

Closer to 10 than 0

Some business models, like insurance-guaranteed returns (i.e. annuities), may have to use capital should current income fall below the yield they need for replacement investments as existing investments mature. Pension funds also evaluate their capital contributions using assumptions for returns, these assumptions are closer to 10 than *Zero*.

Figure 10: Pension Plans still require certain return levels near or above 7%

Change in Median and Average Public Pension Plan Investment Return Assumption



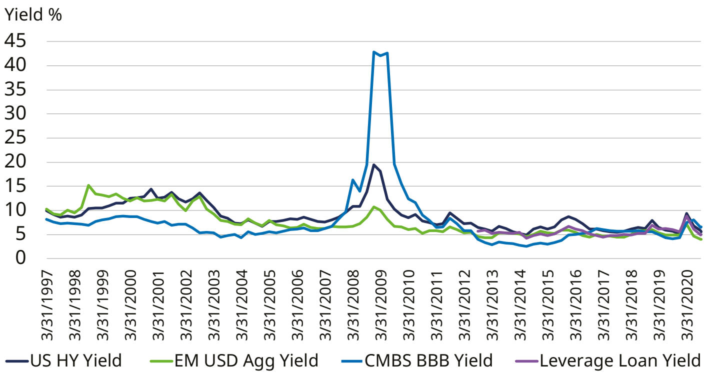
Source: National Association of State Retirement Administrator, June 2020.

Given their required rate of return, there is a prominent case to be made for using alternatives or assets that earn a liquidity premium to achieve additional return through a diversification of risk premium, rather than just additional credit risk.

Regardless, in an environment of Zero, 7% is a tall order.

Over the last two decades, there has been a persistent decline in asset yields below that 7-8% sweet spot. Across the board, it looks like 5% is the new 7%.

Figure 11: When "high yield" looks more like "medium yield"



Source: Bloomberg/Barclays Indexes, S&P leveraged loan index monthly data as of 9/30/20. Yields fluctuate over time.

In light of the near-Zero benchmark rates, we expect that investors will need to look more carefully at the spectrum of risk factors that are tolerable today.

Figure 12 shows a number of market indices and the eyepopping numbers including the very low level of the yields to maturity (YTM), as well as the much higher level of volatility. Using only benchmarks, we cannot easily capture the benefit of diversification, or of asset selection. But we can demonstrate the benefit of a lower volatility product like European ABS, or the attractive yield versus duration ratio of AAA ABS/MBS or AAA CLO. Regrettably for many structured products, there is not an index to show off other comparisons. But the absence of an index is one reason that structured product often offers more compelling yield. That it doesn't sit in a major benchmark means that it may offer a liquidity premium much like we see for private assets. Notably missing from the Figure 12 are attractive diversifiers like real estate debt, which, according to Prequin, offer IRRs of 9%-10%, with lower volatility.

Given today's level of economic uncertainty, asset owners will need to reconsider how they pursue their required outcomes, and reconsider their exposure risk. To be sure, based on today's facts and circumstances: policy support, idiosyncratic risk and disruption, there are factors worth emphasizing and factors worth de-emphasizing. There is merit to taking some risk exposure, specifically exposure that will benefit from accelerating trends.

There will also be opportunities created as the world changes post Covid-19. Access to opportunity, has a place in an investment portfolio. But, there is merit to diversifying that exposure, given uncertainty. By contrast, in a low carry, low rate environment, de-emphasizing duration may be desirable for some, especially if duration is unlikely to play the same role within an asset allocation that it has in other cycles.

We strongly believe that evaluating solutions for #TheZero includes a prudent assessment of factors that can and should be emphasized: stronger fundamentals, better tolerance to volatility, and lower sensitivity to interest rates. Equally required is an assessment of factors that should be de-emphasized. This analysis should be framed within the context of the unique interest rate environment, with a mind for differences from the past that may manifest.

Within a portfolio, each asset should serve a purpose, based on the factors that it emphasizes. The building blocks of a successful strategy will likely require new thinking about sources for return such as: Fast liquidity, Carry, Opportunity or Recovery.

Fast liquidity: For most, some component of a portfolio needs to be used for liquidity. Liquidity is one area that requires a re-examination in light of the changing size of various markets, and the securities within them. Increases in government or corporate debt relative to dealer inventories, the balance sheet of the Fed, among the chief considerations. But in March of 2020,

Figure 12: The Zero has led to a wide range of yield, duration and credit quality options across the fixed income landscape

	Securitized Credit			Global	UK Bond Market		US Bond Market				European Bond Market			Emerging Market Bonds
Sector	ABS/MBS	CLO	European ABS	Global Fixed Income	UK Gilts	UK Investment Grade	US Treasuries	US Fixed Income	US Investment Grade	US High Yield	European Government	European Investment Grade	European HY	EMD
Index	BofA US ABS & CMBS Index	JP Morgan CLOIE Index	Bloomberg Barclays Eur ABS Index	Bloomberg Barclays Global Aggregate Index	Sterling Gilts Index	Sterling Non Gilts	US Treasuries Index	US Aggregate Fixed Income	US Investment Grade	US High Yield Constrained Index	European Government	European Investment Grade	European Currency High Yield Index	EMD Hard Index
Duration (yrs)	3.40	0.25	0.25	7.28	13.39	8.02	7.24	6.12	8.68	3.71	9.45	5.82	3.66	6.73
Credit quality	AA	AA	AA	A-	AA	A+	AAA	AA	A	B+	A+	A	BB-	BBB
YTM (%)	1.60	2.88	0.23	1.50	0.43	1.45	0.48	1.18	2.01	5.27	0.07	0.74	3.82	4.07
1Y volatility	5.62%	10.44%	2.81%	9.42%	7.17%	8.44%	4.63%	3.33%	10.38%	14.97%	4.89%	9.48%	15.97%	13.33%
3Y volatility	3.50%	5.97%	1.62%	6.16%	6.14%	5.48%	4.23%	3.37%	6.83%	9.26%	3.90%	5.68%	9.56%	8.19%

Source: Schroders using data provided by BAML, Bloomberg and JP Morgan, as of September 30, 2020. For illustration only. Indices shown reflect widely used, unmanaged proxies for each respective asset class. Does not reflect any actual portfolio, as investors cannot invest direct into any index. Actual duration, credit quality and performance may differ. Yields are subject to fluctuate over time. Yields reflect past performance which is no guarantee of future results.

the experience was different than the expectation. And with a new set of rules, it is important to re-assess liquidity and its sources. Maintaining pockets of liquidity with as little spread risk as possible, offers an investor, even a return-seeking investor, the flexibility to benefit from further dislocation. We believe this favors securities being bought by the government that do not bear default risk, such as Treasuries or Agency guaranteed MBS. Capitalizing on opportunities as valuations change can be a critical component to seeking to achieve higher returns. This is likely to involve liquidity or complexity premium.

Opportunity: Based on their exposure to certain themes or trends, some products benefit from opportunity, either right now, or down the road. Opportunities today are more likely to include those that are housing related, but future opportunities will include real estate related, consumer related and corporate related. It is important to remember, not all opportunities come at once. For now, it is clear to us that housing benefits from a quality of life trend, and the shelter-in-place demand. But even thinking beyond the obvious, if retirees question the ability of savings to generate income, they may look to lower their cost of living. If financial assets are expected to generate a substandard/low return or low income, individuals may recalibrate their retirement by changing the cost/or expense side of their equation. It is equally possible they move investments, to a barbell of liquidity (for safety) and less liquid assets such as an investment in a home in a desired retirement location, that can be used in the interim to earn rental income.

Recovery: Other types of opportunity can be driven by mispricing. Emotional bias or fear, can be a principal driver of opportunity. Regulation can be another. Recovery opportunities are often the "babies thrown out with the bathwater" in dislocated or uncertain markets. The real estate market facing the impact of change is a good example. In this way, a range of opportunities may be created in both favored sub-sectors (industrial) and loathed sub-sectors (retail, office or hotel).

Carry: Assessing the carry of a bond in consideration of its duration and potential volatility should be a key driver. If this is desirable, our view is that a sector like ABS affords these characteristics more so than many other sectors.

Evolution: Lastly, liquidity takes us into another dimension of risk premium. The terms of liquidity can range in terms of return and in terms of lock-up. This is another tool that could be used to improve or reduce risk within a portfolio in #TheZero, and is likely a potential area that is critical to assess, given that in markets where capital provision is limited, or less efficient, excess return is more likely.

In looking across the landscape, there is a need to solve the problem of #TheZero. Participants in income markets alike will need to consider diversifying sources of return beyond traditional markets, or traditional thinking.

It has been said that "underneath every revolution lay a Zero", and from an asset allocation perspective, this time is no different. We believe that we are just now at the beginning of changes to fixed income asset allocations in order to more aptly navigate #TheZero.

It was the poet, Vanilla Ice, who said, "better drop that Zero and get with the hero". In the context of portfolio allocations, this means with very low structural yields and returns we must consider more risks, rather than just more risk. With that as our guide, we can "stop, collaborate, and listen". Consider a more diverse basket of less correlated assets to embed resiliency. We believe this is the order of the day.

With a wider range of possibility, assessment of liquidity becomes a more important lever. To make available a broader toolkit, managers may need new structures to provide access to some of the asset classes that have typically been accessible only to larger investors. For some there will be more material changes to create a diverse portfolio by using a range of alternative or private assets, non-traditional asset classes, or structures. For others it maybe be a first step into considering a non-benchmark sector with a better income or maturity profile.

This re-assessment is set in an environment of new challenges. The easy sustainability of this recovery may be challenged. Even the delay in the expected US fiscal package has altered expectations. Unemployment perceived as temporary will begin to shift to unemployment perceived as permanent. Policies that helped companies and consumers bide time through non-payment will expire, and we may see another wave of layoffs and increases in bankruptcy filings. We believe these challenges will begin to mark the second phase of this economic crisis and recovery, as we begin to see new data, we may initially see the #deathofoptimism. There will likely be renewed opportunities to benefit from structural changes taking place in the economy, be they social, political or economic.

Generating successful investment outcomes with an uncertain economic backdrop is hard. With high asset prices, and with very little income offered in traditional markets, it is very hard. But as Tom Hanks said in *A League of Their Own*, a movie about women taking over the US Professional Baseball League during WWII, "**It's supposed to be hard. If it wasn't hard, everyone would do it. The hard... is what makes it great**." – and there is NO crying in baseball.

Why company culture matters – and how you track it

Culture is a slippery concept. We all know it matters, but that's where agreement ends. Culture is considered to be an informal institution within an organization: it's the values and norms that guide behavior outside of what is covered by explicit rules or policies. It provides intrinsic motivation for actions beyond the prospects for reward or punishment. It's the spirit rather than the letter of the law.

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Portfolio Manager,
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Why does corporate culture matter?

A business's culture influences its ability to innovate and adapt in response to unforeseen problems and challenges. It determines openness to dissent and debate which can reduce the risk of fraud and "cover-ups".

For example, companies such as Barings, the former UK investment bank, operated a culture where mistakes were not tolerated. So rather than reporting his mistake upfront, 28-year-old trader Nick Leeson tried to make back the money he'd lost in unauthorized trades and eventually drove the company to its infamous 1995 collapse.

How do you assess the effectiveness of corporate culture?

A company's articulation of its culture should be read more as goals – or as advertising – than indicative of reality. The challenge is figuring out whether they "walk the talk". An MIT study finds that 80% of large companies publish their corporate values on their website, but there is a negligible or even negative correlation between official statements and employee views.

Job review websites
When it comes to employee reviews, review website Glassdoor is the most popular source of data given its breadth: 70 million reviews for over 1 million employers around the world. Glassdoor has its shortcomings, but it does benefit from policies and standards that have been shown to reduce the polarization of results and try to prevent companies from cheating.

Job review sites are one of many "go to" sources when analyzing company culture and we have undertaken numerous engagements based on employee comments we have found on Glassdoor.

Academic research
The Culture500 is a tool developed by MIT that uses Glassdoor to profile US companies. It covers companies that collectively employ over 30 million people, over one-quarter of private sector employees in the US. For each company, it scrapes reviews for the nine most frequently cited values and ranks these by frequency (the percentage of reviews that mention the value) and sentiment (whether it is discussed in positive or negative terms). We can compare this with official corporate statements to get a high-level idea of the internal culture of a company.

For example, the chart below shows the mapping for Amazon. It will surprise few people to see that the company is highly regarded for innovation, but criticized for a lack of respect. This is consistent with what we hear from the media and whistle-blowers about treatment of warehouse workers.

Figure 1: Amazon Culture500 mapping

Source: Culture500. Note that the values for each company are normalized so that zero is the average for each value and the axes show standard deviations above or below the average on each dimension. Companies cannot strictly be compared side-by-side based on the values in their company-level mappings, but the site also provides comparison tools within industries for each of the nine values.

For Alphabet (parent of Google), on the next page we can see that positive comments on innovation are offset by surprisingly negative mentions of agility. In general, values such as respect, diversity and collaboration are more highly ranked than at Amazon, providing some reassurance given historic employee unrest over discrimination. Interestingly, the entire big tech sector is less likely than any other industry to have integrity in its values.

Figure 2: Alphabet Culture500 mapping

Source: Culture500. Note that the values for each company are normalized so that zero is the average for each value and the axes show standard deviations above or below the average on each dimension. Companies cannot strictly be compared side-by-side based on the values in their company-level mappings, but the site also provides comparison tools within industries for each of the nine values.

Employee turnover

What about companies without a meaningful presence on any of these sites? An alternative approach is to try and deduce something about corporate culture from more measurable outcomes, for example, employee turnover. If staff are loyal to an institution and stay for a long time, it suggests they're doing something right.

Diversity (of all sorts) throughout an organization can also be a reasonable indicator that a company has a culture of respect and collaboration.

How can investors influence culture?

Culture cannot be installed from the outside. Even if investors could influence it, it is not clear that we should try to. There may be more of a role for investors to engage where there are glaring problems. In these cases, we can initiate a conversation with the management team and potentially push for new leadership or changes in incentive structures to try and establish a fertile environment for cultural change. For example, we have engaged with financial institutions in our portfolio to ensure sales staff are not compensated primarily on quantitative targets which could encourage excessive risk-taking or fraudulent activity.

However, in some cases investor pressure may be part of the problem. Particularly in the US market, where analysts tend to be more focused on short-term results, trying to please investors may push companies towards certain practices that could destroy long-term value.

This highlights the danger of focusing our (and companies') attention on easy-to-measure factors and looking for short-term "wins" from engagement. As long-term shareholders, our most important consideration should be that managers' incentives are aligned with long-term success and that we support companies that may need to sacrifice short-term earnings or dividends for long-term investment.

We should conduct thorough research using a mosaic of qualitative as well as quantitative sources, and use our findings to engage with the company and its other stakeholders.

Lastly, we should encourage an effective corporate culture by prompting executives to talk about culture fluently, frequently and - above all - consistently.

Data, not drama

Uncovering "insurance" against the social ills of corporations

A lot of energy has been put into "proving" the investment value of ESG ratings assigned to companies. In our opinion, that energy has been misplaced.

There is a wide and growing range of ESG rating methodologies, each assessing companies in different ways and, often, coming to very different conclusions. Unlike credit ratings, which are generally very similar from one ratings agency to the next, there is little correlation between ESG ratings at the major ratings providers. Frequently one will rate a company highly while another does so lowly.

As a result, asking whether ESG analysis adds value makes no more sense than asking whether examining financial statements adds value; it all depends what you do with the data.

Andrew Howard
Global Head of Sustainable Investment

Duncan Lamont, CFA
Head of Research and Analytics

SustainEx: Turning theoretical assessments into dollars and cents

A problem with traditional ESG analysis is that, while it allows you to assess if a company is good or bad (based on a given definition of good and bad), it doesn't tell you what the potential financial consequences might be for the company in question. By financial consequences, we mean an objective assessment of the impact on its bottom line, not its share price. You might expect the two to be related but the lack of consistency in ESG measurement underlines the confusion among many investors and the limited chance that the market is effectively discounting those impacts. The combination of very real economic forces on companies and market confusion spells opportunity. Combining thoughtful analysis with disciplined valuation analysis – more on this later – can unlock significant value.

These financial consequences are real and can be substantial. From sugar taxes to carbon credits, companies are increasingly being forced to pay for the costs of the social and environmental externalities that, until recently, society has had to bear. As those costs move onto corporate income statements, industry cost structures and competitiveness will be redrawn.

We have overcome this shortcoming of traditional ESG analysis through a suite of tools that help quantify many of these externalities. One such tool, SustainEx, was recently awarded first place for Impact Reporting and Impact Measurement in the Environmental Finance IMPACT Awards 2020. SustainEx was developed through rigorous analysis of more than 750 academic papers and over 70 data points, applied to more than 10,000 companies. It assigns a dollar value to a company's net cost or benefit from society – that is, its "social value". If, as we expect, these externalities crystallize as financial costs, it gives an indication as to how exposed a given company is. By scaling this dollar amount to a company's revenues, we can assess how material these financial risks are. This also allows us to easily compare one company, sector, country, or portfolio, with another.

By our assessment, global companies typically generate, in aggregate, a negative external impact on society equal to around half their net earnings in a normal year. This risk is too big to ignore.

How much do you have to pay to "insure" against these risks?

Whether to avoid these risks becomes a question of the cost of insuring against them, from a fundamental investment perspective. In other words, do companies with a higher social value cost much more (or have share price valuations) than those which are more damaging to society?

Our analysis suggests that no, they don't!

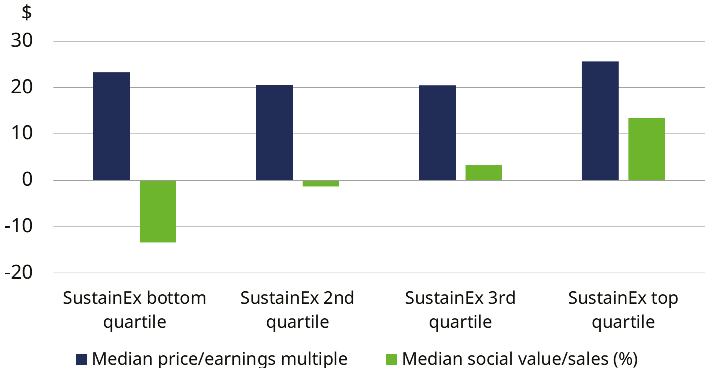
The median price/earnings multiple for companies in the MSCI ACWI which are in the top quartile for social value is only slightly higher those in the bottom quartile (Figure 1 on next page).

And the median company in that bottom quartile has an unrecognized social cost (that is, it has negative externalities) equivalent to 13% of its revenues. In contrast, the median company in the top quartile has unrecognized social value worth 13% of its revenues. Their prospects from this perspective could not be more different.

These are clearly not the only risks to which a business is exposed. However, they are financially material, and our analysis shows that insurance against them is very cheap indeed.

Figure 1: Companies with lower social "risk" do not cost much more

Median price/earnings multiple for companies in each SustainEx quartile



Source: Refinitiv and Schroders. Data as of September 2020. Excluding companies with negative earnings as their price/earnings multiple is meaningless. Based on constituents of MSCI ACWI.

Variations exist across sectors and countries

In most sectors of the global equity market, you don't have to pay much, if anything, to insure against the risks associated with ESG externalities (Figure 2). In several sectors, less risky companies even trade at cheaper valuation multiples. In most others, the valuation premium is minimal.

Only in the materials sector do companies with superior social value cost notably more than those with the worst impact on society. As this sector also scores worse, on average, than any other for its social impact, it is perhaps not surprising that investors have woken up more quickly to the risks this poses to companies operating within it.

Figure 2: ESG "insurance" is cheap across many sectors

Median price/earnings multiple for companies in top and bottom quartile for social value/sales

	Bottom quartile SustainEx	Top quartile SustainEx	Arithmetic Difference
Communication Services	33.2	17.7	-15.6
Real Estate	22.2	7.8	-14.4
Consumer Discretionary	34.8	28.4	-6.4
Healthcare	43.4	37.3	-6.1
Consumer Staples	31.8	29.0	-2.8
Industrials	29.1	28.1	-1.1
Energy	9.8	9.9	0.0
Utilities	15.6	16.6	1.0
Financials	11.8	13.1	1.3
IT	35.5	38.5	3.0
Materials	17.7	30.8	13.1

Source: Refinitiv and Schroders. Data as of September 2020. Excluding companies with negative earnings as their price/earnings multiple is meaningless. Based on constituents of MSCI ACWI.

SustainEx not only allows us to look at the individual company and sector levels, but country views as well. At a country level, greater differences emerge (Figure 3). In markets such as Malaysia, Brazil, China and Canada, companies which impose greater external costs on society are *more expensive* than those with lower risk.

Figure 3: "Insurance" costs more in some countries than others

Median price/earnings multiple for companies in top and bottom quartile for social value/sales for the 15 countries in MSCI ACWI with most constituents

	Bottom quartile SustainEx	Top quartile SustainEx	Arithmetic Difference
Malaysia	39.4	11.5	-27.9
Brazil	38.5	11.5	-27.0
China	32.6	29.9	-2.7
Canada	20.8	18.8	-2.0
Thailand	16.4	17.2	0.8
UK	15.1	16.8	1.7
Germany	13.7	15.6	1.9
Australia	24.7	27.1	2.4
US	25.9	29.2	3.3
Japan	23.0	29.0	6.0
France	17.2	24.7	7.5
India	26.5	37.9	11.4
Hong Kong	26.4	38.6	12.3
Korea	15.8	49.8	34.0

Source: Refinitiv and Schroders. Data as of September 2020. Excluding companies with negative earnings as their price/earnings multiple is meaningless. Based on constituents of MSCI ACWI.

However, in other countries such as Korea, Hong Kong, India, France and Japan, riskier companies cost *far less*. It may be that, in these markets, investors are more concerned about the possibility that companies will be forced to face up to the costs they impose on society, and accordingly have priced it in.

It may also be that sectoral differences are partly behind these regional differences. Sample sizes for individual sectors at a regional level are unfortunately too small to draw many meaningful conclusions.

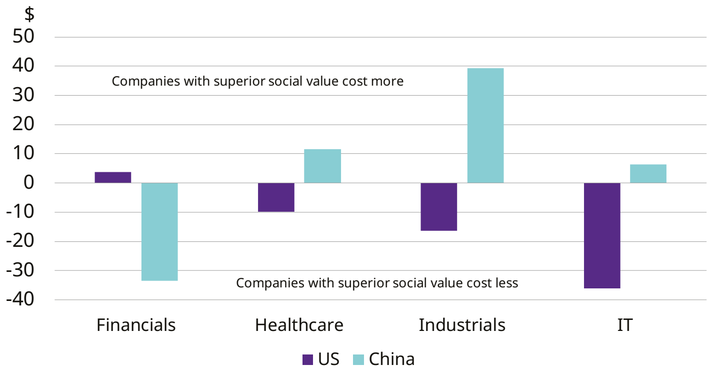
However, a comparison of the most populous sectors in the US and China (markets with the most constituent), highlights some important points. In China, financials, which are more socially valuable, trade on much cheaper valuation multiples than those which are less socially valuable. In contrast, the relationship is much weaker and in the opposite direction in the US. One explanation could lie in the state-owned or state-controlled nature of many Chinese financial companies. Investors could be taking a view that the rebalancing from the state bearing the cost of these externalities, to the corporate sector bearing them, is less likely than in the US.

In contrast, in each of the healthcare, industrial and IT sectors, investors in China would have to pay up for companies which are more socially valuable, whereas investors would have to buy in at a discount in the US.

This goes to show that, when it comes to sustainability, the pricing in of these risks is uneven, even asymmetrical, around the word, based on differing cultural and political situations.

Figure 4: Wide variations exist between sectors across markets

Difference in median P/E for top quartile and bottom quartile companies of social value



Source: Refinitiv and Schroders. Data as of September 2020. Excluding companies with negative earnings as their price/earnings multiple is meaningless. Based on constituents of MSCI ACWI.

Conclusion

Companies which burden society, governments, and the environment with costs are unlikely to be able to escape unscathed in the coming years. These externalities are increasingly likely to be crystallized as financial costs for those that generate them. Some will be material for the companies concerned. The only question is when.

Against that backdrop, to ignore those potential financial penalties when assessing the merits of an investment would strike us as illogical and complacent. You may have a different view on the probability of that happening, or the timeframe over which it could occur, but to pretend they don't exist would be a perplexing risk management technique.

The question then becomes the cost of "insuring" against these risks. Our analysis has shown that this cost is surprisingly low, negative in some cases. However, in the same way that flood insurance becomes much more expensive after an area becomes a flood risk, the cost of this insurance is unlikely to remain cheap once these costs start to crystallize. It is not a time to be complacent.

Green and ESG bonds: what's behind their rise?

Green bonds have been attracting attention for some time, being a key element of the development and growth of sustainable or environmental, social and governance (ESG) investing in fixed income. A green bond is, in short, an instrument to fund projects that have a positive environmental and/or climate impact. More recently, we have seen the emergence of social bonds, used for social investments with aims such as expanding access to healthcare and education.

Saida Eggerstedt
Head of Sustainable Credit

This year has seen something of a growth spurt for green bonds with the market heading toward the $1 trillion milestone, according to data from the Climate Bonds Initiative and Bloomberg. As well as significant government bond launches, there has been increased issuance from the corporate sector and from a wider range of businesses and industries.

Here we look at some of the recent market developments, changes and consider the implications.

Do you think there is any particular reason for the increase in issuance this year, particularly since March?

The investor base in sustainable fixed income has grown and widened. Certainly in Europe, but we have seen more issuers in the US dollar and UK (sterling) markets. It makes sense they try to take advantage and diversify their investor base into (ESG) fixed income investors.

With economies hurting badly due to Covid-19 lockdowns, the policy response from governments has included green and social investment programs. Germany issued green Bunds and we have had EU SURE social bonds, part of the Next Generation EU programme, which includes green investment initiatives. These policies have encouraged companies from Europe, and in-turn we have seen a meaningful increase in the size and liquidity of the market, creating something of a virtuous circle.

Given the inhospitable market conditions, was it easier to issue green bonds because of the strength of ESG industry trends?

Yes and no. Let us not forget that ESG investors tend ask more questions, or at least they should be, about issuers' environmental, as well as financial metrics, while buying ESG bonds. This means the issuers need extra resources and commitment, and a good plan in place for sustainability.

Central bank actions have brought many corporate bond issuers to market this year, across the board, as companies sought to ensure they had sufficient capital as operations were hit by lockdown. Selective issuers have used their green or social or sustainability bond issuance to emphasize their environmental and social initiatives, partly as they reassess their responsibilities in the new world, with the pandemic underlining many of the world's vulnerabilities.

Assessing these bonds from an ESG as well as purely financial perspective gives greater understanding and conviction, positive or negative, in otherwise volatile and uncertain markets.

Have there been any interesting trends emerging amid the increase in issuance, in terms of valuations, use of proceeds, which industries and companies are issuing?

We were happy to see ESG bonds from new sectors, rather than just utility and banks as before. We have seen innovation in terms of sustainability and social bonds, often linked to impact metrics or to UN Social Development Goals (SDGs).

Burberry became the first fashion retailer to issue an ESG bond providing a detailed update on its sustainability strategy. Burberry's aims are: (1) carbon neutrality of operations by 2022 – focusing on energy efficiency and green buildings, (2) focus on sourcing sustainable raw materials, notably cotton certified by the Better Cotton Initiative, this links to the Life on Land SDG, and (3) sustainable packaging. This is an example of how ESG and business considerations can dovetail, given the importance of these considerations to younger consumers.

The issuance of high yield green bonds is a new development. Volvo's China subsidiary and Getlink, the operator of Eurotunnel, both issued BB-rated green bonds. Volvo Car is focused on electric vehicle development. Getlink will use the proceeds to fund clean transportation, energy efficiency, recycling facilities and air conditioning. The framework includes reporting on how proceeds are spent. In the US market we saw pandemic and diversity bonds.

Novartis, the Swiss healthcare company, issued an 8-year maturity bond which carries a coupon step-up linked to ESG targets. Novartis' target is to increase access to medicines in low- and middle-income countries by 200% by 2025. If not, the bond coupon (or interest) increases by a quarter percentage point.

In the US, Xylem, which issued green bonds in June 2020, focused on SDG 6 (clean water and sanitation), SDG 9 (industry innovation and infrastructure) as well as SDG 11 (Sustainable cities and infrastructure). This helped investors to re-assess and appreciate the dedication of the company on water quality, productivity, and resiliency. Plus, the company highlighted how they will help their clients to do more with less -- a central philosophy of Sustainability.

For issuers like Starbucks, the issuance of Sustainability bonds in 2019 which focused on responsible sourcing and training farmers at various coffee-growing countries globally might have inspired the company to further its stakeholders engagement from investing in eco-friendly operations to recently announcing increases in minimum wage to employees.

Have you observed any reduction or variance in quality of the new ESG bond issuance? Has the increase in ESG issuance created opportunities?

Opportunities for sure: for investors, but also for society, given the clear drive among businesses to improve energy efficiency and reduce carbon emissions, and issuers committing to all stakeholders. We do not want to pay too much added premium for ESG bonds, unless we think through improved sustainability the overall sustainability adjusted credit profile improves for good.

It helps sustainable credit investors to create impact on one hand by engaging with issuers and on the other by investing in various SDGs and social and climate causes through increasing public and liquid ESG Bond market.

Are the voluntary industry frameworks such as International Capital Markets Association (ICMA) and Climate Bonds Initiative (CBI) effective?

The International Capital Markets Association (ICMA) has evolved over time, with regular consultation from ESG bond investors and specialists. While voluntary, with no penalty for laggards but recognition for leaders by dedicated investors, ICMA initiatives have been effective in setting a minimum standard, which useful in informing an assessment of a green bond issuer.

ICMA provides ongoing guidance around the purpose of green bonds for instance this year underlining the relevance of social bonds in addressing the coronavirus pandemic. It provided guidance for eligible related projects, such as healthcare research and investment, particularly vaccine development or investment in equipment.

CBI aims at setting, more or less, the gold standard for green bonds, providing certification, however issuers need to pay for this, on top of a second party opinion. The CBI certification for example for Barclays latest sterling green bond makes it eligible for some data providers like Refinitiv to classify it as a green bond which might help green bond only funds. For Barclays, as a whole, one needs a clearer strategy on their transition plan with clients underwriting of fossil fuel related business.

Whether meeting the inclusion criteria for the MSCI green bond index or getting a CBI certificate, for a green bond issuer the best thing is to be as transparent and as future proof as possible through ICMA guidelines and help from credible second party opinion agencies. Using the green bond roadshow to highlight overall ESG strategy, the incentive, commitment and challenges of taking whole business greener and impact metrics and milestones upfront.

How do we measure, assess and analyze the credentials or structure of a green or social bond, and ensure proceeds are being used in the right way?

For us it is important to also assess the overall culture, strategy and direction of any green or social bond issuers. You can then think of the ESG bond as a way of enforcing financial as well as management commitment. Our team of credit-cum-ESG analysts and portfolio managers look at various company metrics and use of proceeds, including carbon intensity reduction and avoided carbon emissions, or hospital beds and social/healthcare facilities created, the number of students helped. Ideally the proceeds are focused on new development but with some allowance for a lookback period (maximum of three years).

In addition to quantitative and qualitative annual reporting on the ESG bond itself, sustainability reports and increasingly the Task Force on Climate-related Financial Disclosures (TCFD) reporting, as well as supplement while financial reporting as well as regular issuers meetings and sector specific ESG analysis are highlights.

Do you think there are any specific rules that would be useful to apply, for example should it be possible for the ESG certification to be revoked retrospectively?

There is no avoiding the responsibility of ESG investors to carry out due diligence and to engage directly with companies and industry bodies, alliances, regulators to dynamically improve and contribute to a greener, sustainable society. A credible second party opinion on an ESG bond is helpful, but the analysts' issuer assessment is crucial. As with a credit rating from an agency, social or green certification plays a role, but is not the sole factor for active engaged investors.

What are we seeing in terms of trends or developments in 'Use of Proceeds', and what is it telling us about companies' key ESG considerations and priorities?

Overall we see companies thinking bigger, expanding their ESG horizons. Green considerations are not just about a company itself, but aligning with the goals of the Paris agreement. The issue of green buildings has been a success story, particularly around certification of new buildings; it is now widening to energy efficient renovation and its role in a circular economy, including waste and water management. Social was often about affordable housing, but it is incorporating access to education and medicine. A responsible issuer looks at inclusion in its business from racial, gender, income, mental and physical capability, and issues a social or sustainable bond for this purpose. We have seen early moves here.

What is your view on more prescriptive measures, such as segregated accounts for ESG bond proceeds?

I think those types of measures represent the ideal, but are not always realistic or practical, and they are not essential. Of equally, if not greater importance is the "greenness," or the positive social impact of the use of proceeds, which is best monitored through engagement.

A separate account might tick a box for auditors, but it can be onerous, creating administrative factors to be managed. It's more important that the ESG bond is not just a one-time venture, it should be part of adoption of a greener or more socially-minded orientation, and activities consistent with this on a larger scale.

In our view, the main purpose and advantage of credible and topical green or social bonds in a corporate bond portfolio, regardless of vehicle type, is increased exposure to sustainable investment and diversifying exposure to future themes.

Why investors in China private equity might be missing out on most of the market

The domestic Chinese private equity market is developing faster than many international investors realize, but without the right fund structure investors may miss the best opportunities. We explain why.

Rainer Ender
Head of Private Equity

Jun Qian
Head of Investments China and General Manager

Tim Boole
Head of Product Management

A lot changes over a decade, especially when it comes to private equity, and especially when it comes to China. The domestic private equity market has grown rapidly, and offers a range of opportunities with tremendous growth potential.

However, without the right fund structure, international investors simply can't access many of the deals that we think are the most exciting.

Chinese private equity has become (mostly) self-sufficient...

When Schroder Adveq launched its first dedicated Asia private equity fund in 2006, focused on China, international investors were the principal source of private equity capital for Chinese companies. Now international investment is dwarfed by domestic renminbi (RMB) funds.

In 2007, approximately $40 billion was raised from international investors for private equity in China, eight times more than funds raised domestically. In contrast, 2019 saw $163 billion raised domestically and just $22 billion from international investors.

There are a number of reasons for the change. The first is that many Chinese companies – particularly smaller firms - simply do not need to look outside Chinese borders. Deeper pools of domestic capital in China's RMB funds reduces the need for companies to source overseas capital.

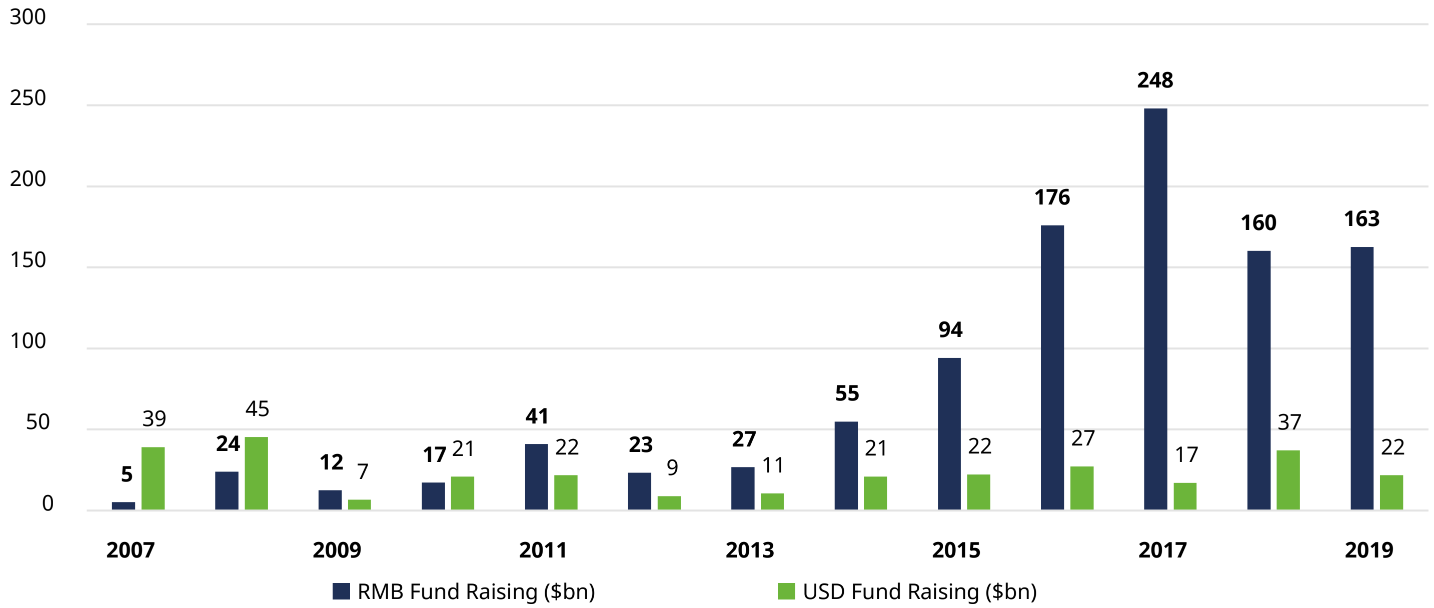
Secondly, domestic capital comes with fewer government restrictions on the industries in which it can be invested.

Thirdly, there are efficiency savings by raising and investing capital in RMB funds, due to simpler ownership structures and transaction process.

Finally, the development of domestic stock exchanges, especially the STAR Market[1], support domestic listings by reducing restrictions that previously limited young growth. The IPO market has developed such that domestic Chinese company listings now account for about one-third of IPOs, worldwide, by number.

[1] STAR Market: Science and Technology Innovation Board is a pilot program that, amongst other things, allows companies to list before they have turned a profit.

China PE market fund raising 2007–2019 (US$ billion)



Source: Zero2IPO, Schroder Adveq, 2020. Note: Includes government guidance funds.

Many opportunities are only available in RMB funds

International capital is still sought-after for medium to large Chinese companies, those with international growth firmly on their agenda. For these companies, foreign listing or M&A are still commonplace. Alibaba listed on the New York Stock Exchange in 2014, and Baidu listed on the NASDAQ in 2005.

However, the rapidly developing onshore renminbi (RMB) market is where we think investors need to look for the most attractive opportunities. RMB funds offer access to several key themes:

1 **Small and medium sized enterprises**
30 million[1] businesses that play a key role in the growth engine of the economy outside of the dominant, state-owned enterprises.

2 **"Made in China 2025"**
A key government initiative to support businesses is called "Made in China 2025", and focuses on target areas including technology, aerospace, biotech and high performance medical equipment.

3 **Domestic service sectors**
Focus on those sectors that stand to benefit most from the increased disposable income of a growing urban middle class.

The growth of the private equity market in China is also leading to exciting developments in the RMB secondaries market. On the supply side, the growth in private equity fundraising over the last ten years, along with the dependence on private investors, has generated a large source of secondary opportunities. On the demand side, there are few institutional investors, especially with secondary transaction expertise. The mismatch between supply and demand offers attractive discounts.

[1] Ministry of Industry and Information Technology (MIIT)

In addition, RMB funds can secure co-investment opportunities - where speed plays an important role in winning a deal. RMB funds have an advantage over US dollar funds by having pre-settled currency exchange and onshore investment structures.

The "all access pass" to domestic opportunities

The Chinese government still carefully regulates international capital flow into and out of China and restricts foreign ownership of Chinese companies in certain industries. To date, private equity managers have used US dollar funds to overcome this to transfer capital into Chinese companies, often as "Foreign Direct Investments".

The Chinese government has gradually opened up its domestic capital market to both domestic and international investors for the past two decades. Specific investment programs have been launched and industry investment restrictions have been rolled back. Between 2017 and 2019 foreign investment encouraged industries have increased by 20% while restricted and prohibited industries have decreased by 55%.

Moreover, gaining direct access to the wider market available in domestic RMB opportunities still requires a specific fund structure, called a Qualified Foreign Limited Partner (QFLP).

Until 2010, foreign private equity managers and investors had been restricted from establishing onshore funds in mainland China. A change in law opened this up, along with the launch of a QFLP pilot program in 2011, which introduced a number of benefits. Previously, for example, conversion between RMB and US dollars required separate approval for each transaction. Under QFLP, this approval is done at the launch of the fund which improves the agility to make investments.

Establishing a QFLP fund is, however, still a highly regulated process and requires multiple approvals from government agencies. The manager of the fund must themselves be regulated and is subject to minimum staffing and capital levels. The QFLP funds raised are also subject to requirements on capital, limited partner (LP) composition and a domestic custodian. It is partly for this reason that the number of foreign managers with QFLP funds has remained low given the level of commitment required to support an onshore business.

How should investors respond?

Our experience so far has been that international investors interested in RMB private equity already have experience of investing in China through USD funds. These sophisticated investors want to diversify, and access what has become the larger pool of private equity investment potential. It is this last point that we believe makes RMB private equity investing relevant to a growing number of institutional investors seeking a diverse portfolio exposure to China.

While USD funds will remain the starting point for most institutions investing in Chinese private equity, the investable universe is expanding fast outside of the current 300 active USD fund managers with at least 10,000 RMB registered fund managers added.

The recent geopolitical tension between China and the US, especially the focus by US legislators on Chinese companies listed on US exchanges may well add to the case for RMB fundraising to be the first choice of more companies.

There is no denying that investing in RMB funds requires access to the local network of managers which itself takes considerable time to understand. While the market has grown significantly over the last ten years, having an experienced team on the ground that knows the RMB managers is key.

What we have witnessed over the last 10 years is not a short-term change but is part of a long-term shift in the world's second largest private equity market and second largest economy. It is therefore only likely to climb in relevance for international investors when thinking about portfolio construction and diversification.

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