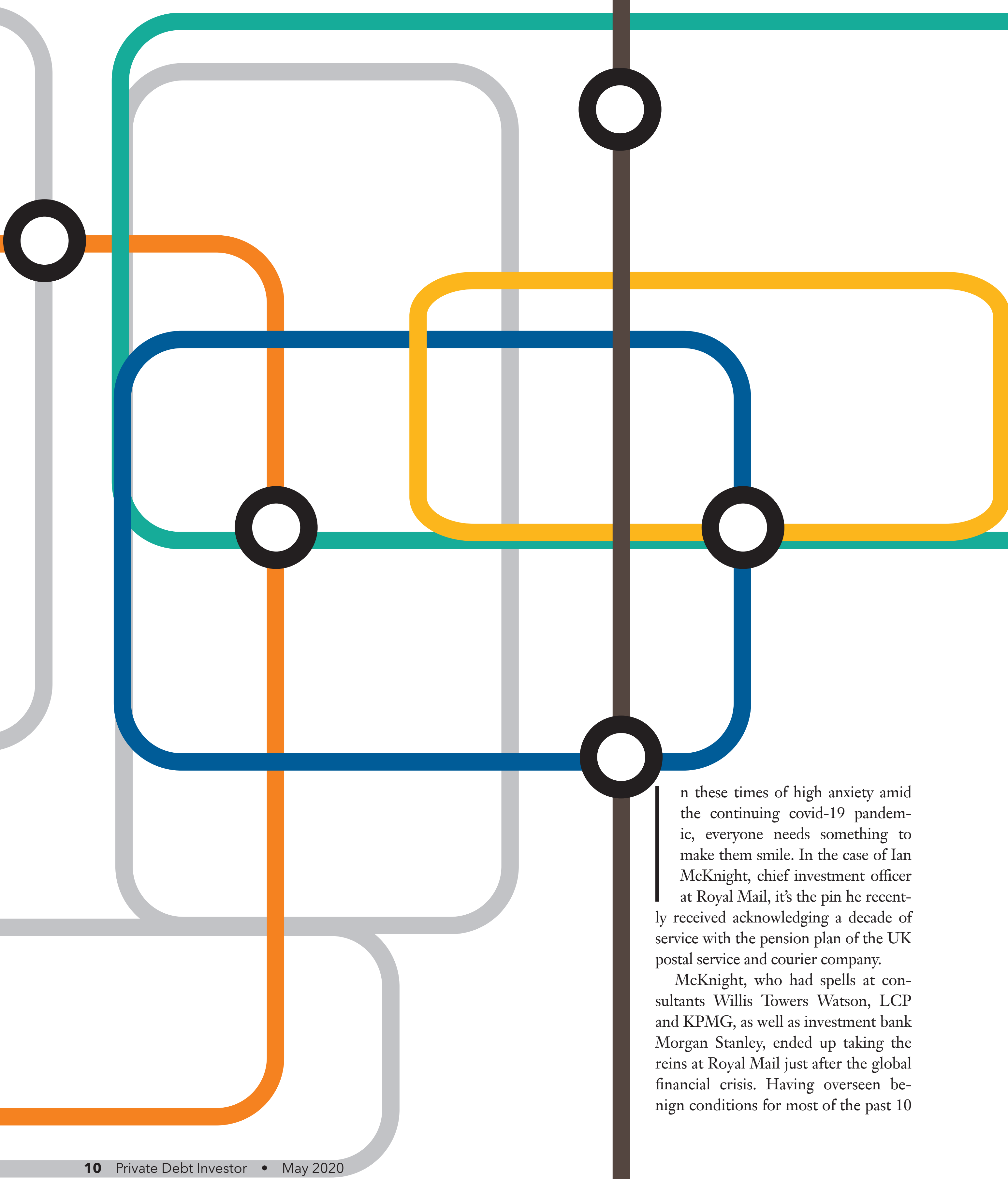


In these times of high anxiety amid the continuing covid-19 pandemic, everyone needs something to make them smile. In the case of Ian McKnight, chief investment officer at Royal Mail, it's the pin he recently received acknowledging a decade of service with the pension plan of the UK postal service and courier company.

McKnight, who had spells at consultants Willis Towers Watson, LCP and KPMG, as well as investment bank Morgan Stanley, ended up taking the reins at Royal Mail just after the global financial crisis. Having overseen benign conditions for most of the past 10

The LPs taking different directions

Many investors have come to private debt from fixed income and are conservative on risk/return. We examine those with bold takes on portfolio construction. Royal Mail is at the forefront, Andy Thomson reports

Cover story

years, McKnight was not among those surprised that a new crisis came along eventually. "You never know what's going to tank the market, but we've been worried something would disrupt it for the last 18 months," he says.

McKnight is not making any hasty moves in response to covid-19. He simply says: "We are watching carefully how the market develops over the coming weeks, and how managers behave around this time will lay down a marker for investors looking at them in future."

Sitting next to McKnight (the interview was conducted just before social distancing was introduced) is Bev Durston, managing director at Australia-based Edgehaven, the institutional advisory business she founded in 2013.

McKnight says Durston is effectively – although not officially – the pension's head of alternatives. While Durston visits London regularly – or did prior to the pandemic – Edgehaven colleague Bill Bastow spends three days a week in London working from Royal Mail's offices with its existing managers.

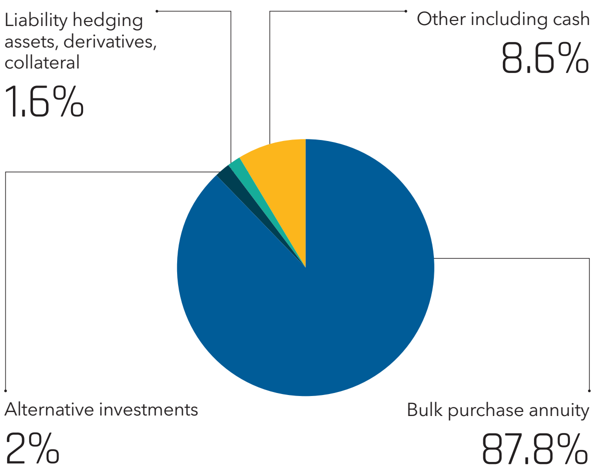
Reflecting on how Royal Mail had been selecting its alternatives managers prior to the pandemic, Durston says: "We have been more cautious in the types of managers that we go with and highly selective in the funds that we think are interesting. We've moved in certain areas from equity to mezzanine and from mezzanine to senior, so we've become more cautious in the overall level of risk we're taking."

But while this may have set up Royal Mail to weather whatever storms lie ahead, the fact is that conservatism is not likely to be the first word market sources reach for when asked to describe the Royal Mail approach.

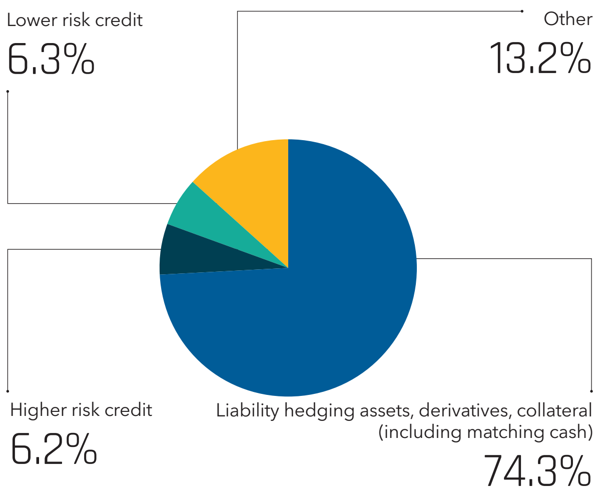
Forward-thinking

Indeed, when *Private Debt Investor* canvassed the market for views on

Post Office asset allocation up to 31 March 2019



Royal Mail Group asset allocation up to 31 March 2019



Source: Royal Mail Pension Plan

which limited partners had the most forward-thinking and innovative approaches – being prepared to consider strategies and geographies others probably wouldn't – Royal Mail received a strikingly large number of mentions. "They have a strong allocation to alternatives, always looking for niche strategies and good risk/reward," says one source.

Durston describes how this adventurousness has manifested itself: "Over the last seven years, we've done a variety of things. We've cornerstoned three funds and we've gone into specialist structured credit, US and European mezzanine debt, Asian private debt, an Asian fund with a mixture of public and private, Asian special situations and capital release strategies, for example."

If there's a stronger Asia-Pacific flavour to that than you might expect of a London-based organisation, that's no coincidence. Durston, an Australian national, has been a bit of a globe-trotter in her career. In Australia, she was deputy chief investment officer of superannuation fund Sunsuper and head of investments at SuperEd, the super fund advisory firm. She was also a senior portfolio manager at GIC in Singapore. Having also spent part of her career in the UK – where she was head of alternative assets at British Airways Pensions from 2008 to 2013 – she is now back in her native country with Edgehaven. Royal Mail was the anchor client when she launched the consultancy in 2013.

Having expertise effectively 'planted' in the region is a distinctive feature of Royal Mail's alternatives programme. "It's a complex region," says Durston. "We're in 12 jurisdictions, 12 legal systems. It takes you time to get from one country to another. You can't just nip across countries like you can in Europe, it takes you 10 hours to get from one side of south-east Asia to the other. Thankfully we've found some really good managers which have exposure and offices across the region."

McKnight says there has been a wariness on the part of fund managers towards China because of the licence required to operate there, and Durston acknowledges that the return needs to be higher because of the additional

Selection of private debt managers backed by Royal Mail

Manager	Commitment (as at 31 March 2019; £m)
Intermediate Group	77
Highbridge Capital Management	65
Empyrean Capital	39
Quinbrook Infrastructure Partners	16
Crescent Capital Group	14
Centerbridge Partners	10

Source: Royal Mail Pension Plan

risk. She says the Asian special situations fund Royal Mail committed to has made an internal rate of return of around 16 percent net, whereas similar strategies in Europe have only been delivering around 8-11 percent.

Special situations and distressed, whether in Asia-Pacific or elsewhere, has been a theme Royal Mail has pursued with enthusiasm – mainly through contingent funds, where "we put a small amount of money in, on the understanding that we're going to commit much more as and when there's a period of distress", according to McKnight.

"You do that with the better managers," McKnight continues, "because we like to be on the front foot with a tailwind and get in early. When everyone else has cottoned on and think 'now's the time', that's when you get all the me-too funds launching and they don't have the best access to deals, which is the key to it all."

With private debt funds generally only prepared to pay fees on invested – rather than committed – capital, Durston describes contingent distressed funds as "a play on optionality". Right now, with businesses struggling to navigate a way through the coronavirus crisis, it seems like a nice option to have.

Zero to low correlation

It's no accident that Royal Mail has come to be associated with an open-minded approach. McKnight says the plan was always for the alternatives portfolio to be "zero to low correlation to everything else we have [in the portfolio]."

Lending credence to McKnight's claim that "we've had very little go wrong", Royal Mail says its private debt portfolio has returned 9.1 percent a year since inception in 2013. During that time, Durston says nearly $1 billion has been committed and about $600 million invested. "The public market equivalent for this portfolio is the global high-yield debt portfolio and that's delivered 5.4 percent, so we're 3.7 percent above where we'd be if we'd put this into a more liquid strategy with a similar kind of credit risk."

So, have any of the more exotic strategies failed to live up to their billing? McKnight pauses. "The only one I would flag is shipping. We had some exposure to shipping, and it did come through and make money, but it was the least successful strategy and luckily we avoided overweighting it."

Durston adds that the strategy delivered around 5 percent, making it the only private debt strategy backed by Royal Mail not to reach its performance hurdle.

Summing up the Royal Mail approach, Durston says: "Essentially, we're looking for smaller managers or niche, specialist ideas where other people aren't hunting and some of the larger consultants can't allocate as there is not the capacity for much larger AUM."

> *"There's going to be a lot of pitfalls coming down the line with people scrapping around trying to prop up failing businesses"*
>
> **IAN McKNIGHT**
> **Royal Mail**

McKnight says avoiding crowds is key. "We steered clear of mid-market US direct lending a few years ago because everybody was going into it. Trying to balance the scale necessary to cover that market properly with the

> *"We're 3.7 percent above where we'd be if we'd put this into a more liquid strategy with a similar kind of credit risk"*
>
> **BEV DURSTON**
> **Edgehaven**

need for alignment of interest is quite a juggling act."

He points out that Royal Mail has gone into the direct market, but by dealing directly with family owners. "A lot of our European managers do corporate deals directly with families for high-teens returns where they're acting almost as a private equity firm but instead of taking equity, they're taking mezzanine and offering consultancy advice to the families. A lot of these firms want to move towards an exit and don't want to give away a large slice of equity to a PE firm."

The only way to make a success of what will become a major investment theme, McKnight suggests, is to access it at the pioneering stage where it's just getting off the ground. "If there's a big trend coming through and everybody's talking about it, the odds are we probably bought it last year."

'Straight talking and blunt'

One consultant *PDI* spoke with described McKnight as "straight talking and blunt but extremely helpful. He's far from a traditionalist in terms of approach and has some strong views on what's wrong with the industry".

In person, while faultlessly friendly, there are some hints that McKnight can become a little animated when reflecting on the industry's failings. One of these is the accumulation of assets under management for the sake of it rather than for a particular rationale.

"We've stuck with managers which have maintained a sensible fundraise size through cycles and not increased it dramatically and we've avoided managers that have a fund but have also been offering large segregated accounts to people, because we often can't tell what the total fundraise size is. Those guys are basically more about asset gathering and less about outcomes."

As a firm that prefers to back specialists, another pet hate of McKnight's is managers that are not close enough to the assets to really have a deep understanding of what they're exposed to. "There's a classic example of this in the liquid world where people were trading CLO [collateralised loan obligation] tranches without any understanding of the underlying assets. They were just technical traders watching a screen and that's deeply concerning. You had a great number of market participants who didn't understand what they were buying."

This kind of disconnect between managers of money and the assets they were investing in was of course a characteristic of the global financial crisis. As with the GFC, the covid-19 crisis will invite close scrutiny of manager and investor behaviour in times of stress.

"There's going to be a lot of pitfalls coming down the line with people scrapping around trying to prop up failing businesses and I think it's time to tread carefully," notes McKnight. ■

Post-covid priorities

Bev Durston on key issues for investors in today's climate

- Assessing the existing portfolio of private market funds. This is both for those still investing but with more of a focus on those who are now harvesting/already largely invested.
- Reassessing forecast cashflow to expect lower realisations and some (distressed and special situation) funds drawing down more quickly in H2.
- Watching for the "denominator" impact on asset allocations now public markets have downsized. Also judiciously reserving or suspending rebalancing until the lagged valuations catch up in private markets.
- Reassessing potential fund ideas at these much lower levels to re-underwrite them and confirm if they still remain the best opportunities in this fast-changing environment.
- Modelling credit at stresses beyond the GFC for default and loss given default assumptions. The governments can't rescue everyone in this environment, there will still be winners and losers.