

Higher returns and lower portfolio risks: Attracting institutional capital for development

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Summary

This brief reconsiders the current strategy for mobilising institutional capital towards climate and sustainable development goals (SDGs) investments in developing economies. The existing approach, which focuses primarily on why investors 'should' care about the SDGs and climate and dangles subsidies via various blending vehicles, addresses the issue at the margin. It has failed to achieve investments envisioned by the 'billions to trillions' agenda.

Policymakers and advocates for mobilisation should shift their focus towards highlighting the higher prospective returns and risk reduction via diversification available to institutional investors from reallocating significant proportions of their portfolios towards developing economies. These regions offer better growth prospects and are structurally different from the rich economies where current portfolios are concentrated. Key measures include educating investors on the growth potential of emerging markets, minimising regulatory biases that currently favour OECD investments and strengthening the governance of institutional investors.

This brief shows how growth is increasingly concentrated in developing economies, driven by favourable demographics and rising productivity, which contrasts with the stagnation in advanced economies. It shows how, for institutional investors seeking higher returns and reduced portfolio risk, reallocating capital towards developing economies is a financial imperative, independent of where they stand on climate or the SDGs. The brief calls for enhanced coordination among EU regulatory bodies to facilitate this shift. Additionally, it advocates for making a more rigorous risk-return case for developing economies as an investment destination, complementing the current focus on blended finance mechanisms, climate imperative and SDGs-related impacts.

Introduction: To attract capital at scale, we need to reset the current approach to mobilisation

The current strategy for mobilising institutional investors for climate and SDG investments in developing economies has not delivered on the promise of '[billions to trillions](#)' and requires a reset. The prevailing approach has so far addressed this issue at the margin, by seeking to convince investors to care about social, development and environmental outcomes as well as the business case while relying on complex, often subsidised financial solutions such as blended finance to make investments more attractive.

Had the 'first order' case for enhancing returns and reducing risk by investing in developing economies been weak, this "second order" approach of focusing primarily on values, and subsidies would make sense. But, as this policy brief, which builds on a long body of work with institutional investors, the G-20, researchers, and policymakers shows, the 'first order' risk-return imperative for reallocating portfolios towards developing economies is overwhelming.

Thus, to mobilise capital at scale and speed, the emphasis of mobilisation efforts should shift towards showing how investments in developing economies align with investors' primary objectives of maximising returns and minimising risk.

This will need to involve measures such as 1) improving the understanding of 'shortfall' risk for pension funds investing primarily in slow-growing Organisation

for Economic Co-operation and Development (OECD) economies, 2) rigorous investor education on the enormous growth potential, and diversification benefits in developing economies, 3) minimising regulatory distortions (prudential and financial regulations/requirements) that drive an OECD country bias and particularly affect insurance companies, 4) strengthening the often shoddy governance structures of institutional investors, and 5) building more capacity and expertise on dynamic Asia, Africa and Latin American economies with the investing, regulatory and policymaking communities within OECD economies in general, and the EU in particular.

The primary argument being made to institutional investors needs to shift away from why they 'should' invest in developing economies to help fund the SDGs and climate action to why they 'must' make such investments at scale both to boost falling returns and to diversify away some of the excessive risks they have built up in their portfolios. Such an approach would need to engage supervisory boards, regulators, finance ministries, central banks, investment committees, portfolio managers, investment managers, risk professionals, and investment consultants rather than focus primarily on the subset of Environmental, social, and governance (ESG) and Impact investing professionals. In the EU, this would mean strengthening the coordination between DG INTPA, DG NEAR and DG CLIMA, and DG ECFIN, DG FISMA and regulators such as ESMA and EIOPA, which need to actively engage and, in some cases, lead on specific issues relating to institutional investors' mobilisation.

This will complement the existing 'pull' approach to mobilisation with a 'push' by investors to reallocate portfolios towards the higher returns and risk diversification that fast-growing developing economies offer. That such a reallocation offers superior impact, helps fund SDGs, and delivers climate action is not the primary attraction, but the cherry on the top of seeking higher returns and diversifying portfolio risk.

In this policy brief, we take a first-order approach that focuses on the prospects for the global economy and the risk and return landscape facing institutional investors. We show how a large-scale reallocation of their portfolios towards developing economies is central to their first-order goal of maximising long-term returns while diversifying away as much risk as possible.

Economic growth has shifted away from developing towards developing economies for good

Over the very long term, there are only two primary drivers of [economic growth and prosperity](#). These are [natural capital](#), broadly defined, and human ingenuity and creativity, also called [human capital](#). Technology, Physical Capital, Intellectual Capital and Financial Capital, all drivers of growth in the near term, are nothing but the accumulated surpluses of human ingenuity putting natural endowments to ever more productive use, and they all originate from some [combination of human and natural capital](#) in the first instance.

Thus, the growth potential of an economy is strongly linked to its human capital, which in turn depends substantially on an economy's demographic profile (quantity) and the education and training of its workers (quality). All else being equal, economies with rising working-age populations, and rising worker participation grow faster owing to a rise in the number of workers while shrinking populations have put a [0.9%-1.3% drag](#) on growth prospects. The dependency ratio (share of population aged 20-64 compared to share of over 65s) in the EU has [fallen dramatically](#) from 3.8 in 2003 to 2.7 in 2022 and may fall further to just 1.5 over the coming decades.

Historically, around half of the rapid growth seen in rich economies in the post-World War era for several decades came from an actual [increase in the number of workers](#). But this driver has now become a drag on growth instead, with the number of workers shrinking not just in Japan, but also in many countries [in the EU](#) and most [other rich economies](#). Birth rates in 38 of the world's advanced economies have more than halved from 3.3 in 1960 to 1.5 now with countries in Southern Europe and Japan at 1.2 and South Korea holding the record of just 0.7, all far below the [replacement rate](#) of 2.1 necessary to maintain a steady population. Prospects for gross domestic product (GDP) growth in rich economies have [fallen sharply](#), with a 1% growth rate for Japan, 1.5% for the EU and 2.0-2.5% for the United States of America (USA) seen as [decent outcomes](#).

These dismal growth prospects contrast sharply with growth prospects in developing economies such as India, where the [World Bank](#) just revised its expected growth rate up to 7%. Of the nearly 50 countries expected to grow at

4.5% or faster in 2024, for example, not one is an advanced economy, with the [vast majority](#) being developing economies in Asia, Africa and Latin America. The higher growth potential stems partly from favourable demographics, wherein around [12 million Indians](#) join the workforce every year, a bit larger than the [10 million Africans](#) who enter the workforce every year. Demographics are a tailwind in much of the developing world, boosting potential growth rates, even as they drag them down in rich economies.

The other half of growth in advanced economies, in the post-World War era, was accounted for by a steady rise in productivity. However, that too has slowed down dramatically more than halving from an annual increase of 2.2% in the five years to 2002, to an annual increase [of less than 1%](#) in the years to 2022. Productivity growth in developing economies has also slowed down but has remained at a [much more significant 3.4% level](#) in the most recent decade. Research has shown that poor demographics also [acts as a drag](#) on both innovation potential and productivity growth.

This average conceals significant differences, but according to McKinsey, a consultancy, more than 30 developing economies with a total population of 3.6 billion are in a fast lane of catch-up growth that would see their productivity levels converge to those of advanced economies before 2050, while some others, accounting for 1.4 billion people, are stuck in a slow lane that will not see their income and productivity converge.

Analysis by [Goldman Sachs](#), an investment bank, also reinforces the conclusion that despite a general slowdown in global economic growth, many developing economies have continued their rapid catch-up with developed economies, a trend they expect to continue over coming decades. According to Ruchir Sharma, an emerging market specialist, the proportion of emerging markets with growth rates faster than that of the US will surge [to 88% from 48%](#) over the past five years.

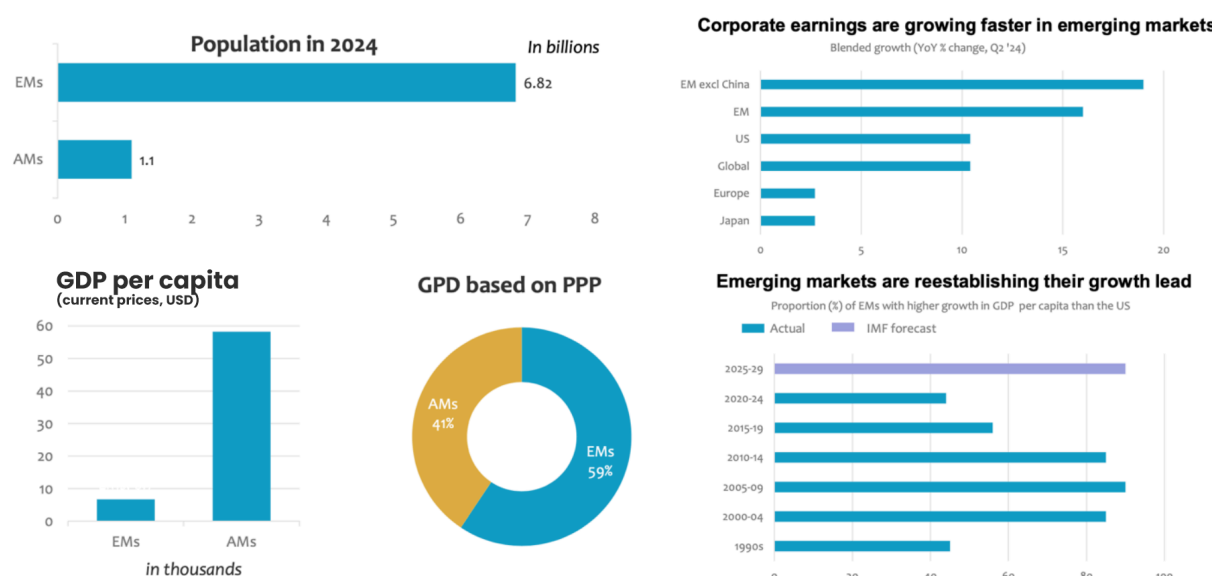
In fact, over the last decade, developing economies contributed the most to the growth of global GDP with only one rich economy, the USA, showing up in the list of top ten. China, India and Indonesia alone accounted for [more than half of all global growth](#) seen in the past decade. Already half of global GDP, 2/3 of all global growth, and half of middle-class demand underpinning prosperity comes from the developing world, and [its share](#) is expected only to rise. Despite this,

developing countries account for only one-fourth of stock markets, one-sixth of bond markets, one-tenth of private equity, and half of foreign direct investments.

Where goes economic growth, business and profit opportunities also follow

As their GDP and income per capita continue to rise faster than those of rich economies, developing countries will also see a rise in their share of global equity markets, with emerging stock markets expected to exceed the market capitalization of US stock markets by the end of this decade already, according to [Goldman Sachs](#). By 2050, developing economies are expected to account for a larger share of global stock markets than rich economies.

Figure 1: Emerging markets: The future growth engine.



Source: [APG](#)

One of the most remarkable characteristics of financial markets over the past few decades has been the exceptional performance of developed country markets, especially the US stock market even [in the face of slowing](#) and sclerotic growth. For example, the S&P 500 index of US stocks has delivered compounded real annual returns of between [5.5%](#) and [7.5%](#) depending on the exact period and method of calculation (whether dividends are reinvested or not) used in an economy that has only grown at [a real rate of 2.5%](#) over the same time. As we discuss below, this [cannot continue](#) for much longer.

While economic growth and stock market performance are only [loosely related](#) over the [short to medium](#) term, profits are likely to rise faster, and asset valuations tend higher in economies that are growing faster over the longer term. Earnings in emerging markets, excluding China, are expected to grow at 19%, nearly double the level expected in the [US](#), where after many years of unexpectedly good corporate earnings, [a slowdown](#) is now imminent. Some forecasts expect the market capitalization of the Indian stock market to more than double to around \$10 trillion by 2030, after several years of rising earnings and valuations driven by India's [booming growth](#).

Knut Kjaer, the former head of Norway's Sovereign Wealth Fund and current chair of the supervisory board of APG Asset Management, which manages the assets of ABP, the largest pension fund in Europe, agrees with the analysis. In a recent interview where he spoke in his personal capacity agreeing that there were "great investment opportunities" in emerging markets, especially in Asia, which [he described](#) as a future growth engine with potential strong corporate earnings. He reinforced that message saying "At APG, we think that there are great return and diversification opportunities in emerging markets, but we also think that we have a lot more impact for the effort we [do] in these markets".

The historic outperformance of developed country financial markets cannot continue

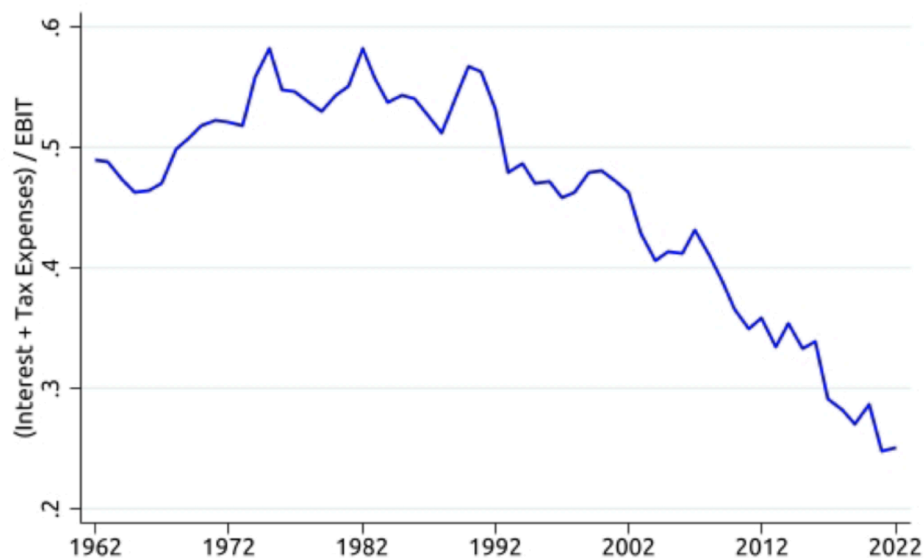
While the large and sustained outperformance of developed country stock markets, the US in particular, over modest GDP growth rates may appear to defy gravity and explanation, looking under the hood at the drivers of this performance yields useful and interesting insights and prognosis. In our [previous work](#) for Norfund, and the [Norwegian government](#) on the giant [\\$1.8 trillion](#) Oil Fund, the largest Sovereign Wealth Fund in the world, we have dissected all the drivers of the supernormal returns and shown why [prospects look far bleaker](#).

One of the biggest drivers of these returns has been the secular decline in US (and other) interest rates from the 1980s until the recent hikes of 2022 and 2023 of about 7%. Falling interest rates increase valuations. A second driver of supernormal returns has been a near halving of the corporate tax rate in rich

economies over the same period from about 40% down to about 20% now increasing the post-tax corporate profits investors most care about.

A third big driver has been the two huge bouts of [quantitative easing](#) undertaken by (mostly) rich country central banks in response to the global financial crisis of 2007–2008 and the COVID-19 pandemic of 2020–2022 amounting to between [\\$15 trillion and \\$20 trillion](#), which inflated asset prices, particularly in the rich world. A fourth driver has been the redistribution of productivity gains [away from labour towards corporate profits](#) in recent years, driven largely, but not solely, by the integration of Chinese, East Asian and Eastern European workers into global supply chains, especially for goods, but this has also now run its course.

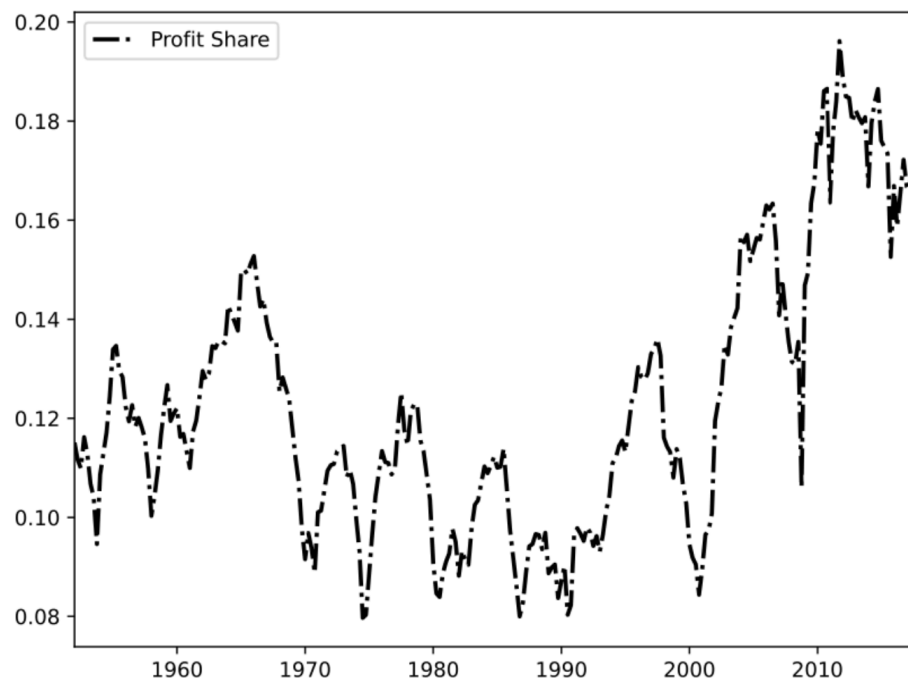
Figure 2: Interest and tax expenses as a share of EBIT.



Source: [US Federal Reserve Board](#)

A recent paper from the US Federal Reserve Board reinforces and supports our historical analysis and the grim prognosis for [future returns](#) from investing primarily in rich economies. According to the Fed, the lower interest rates and corporate tax rates alone explain nearly half of the profit growth in the three decades up to 2019, and the secular decline in interest rates was responsible for most of the increase in the price-earnings multiples, at least in the US. The paper forecasts significantly lower profit growth and stock returns in the foreseeable future.

Figure 3: Evolution of Profit Shares.



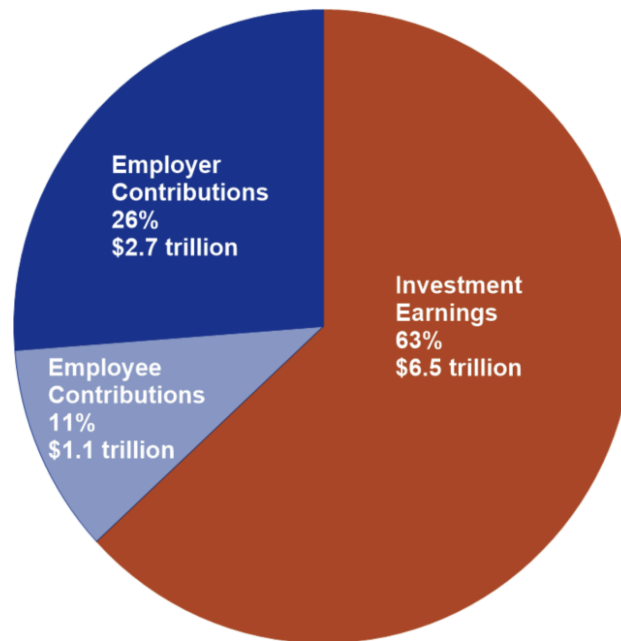
Source: [NBER](#)

Figure 4: Double-Quick Time: The Dow doubled in 7 years – its previous doubling took almost 18 years.



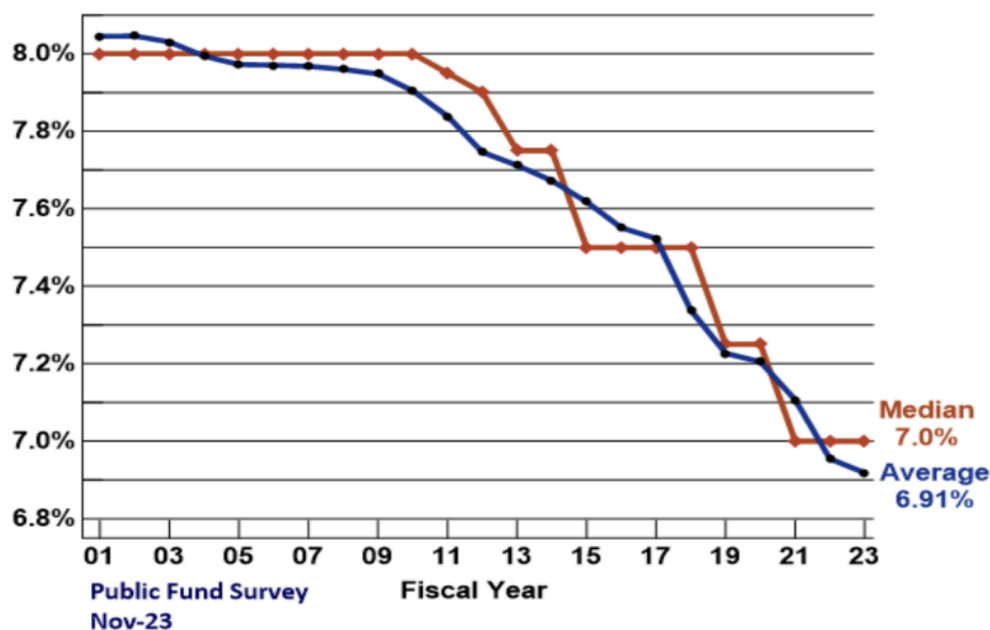
Source: [Bloomberg](#)

Figure 5: Cumulative sources of revenue into public pension funds for the 30 years ended in 2022 (US Census Bureau).



Source: [NASRA](#)

Figure 6: Change to Average and Median Investment Return Assumption, FY 01 to present.



Source: [NASRA](#)

So outsized have the financial returns from investing in rich economies, particularly the US stock market, been, that a significant majority of the corpus of the world's largest institutional investors has come from accumulated financial

returns rather than new inflows in the form of oil revenues, pension contributions or insurance premiums. For example, nearly 60% of the nearly \$1.8 trillion held by Norway's oil fund, more than \$1 trillion, has come from [investment returns](#), with inflows of oil revenues having contributed less than half of that to the value as of mid-2024. For North American pension funds, financial returns have constituted an even larger proportion of the current corpus, [well over 60%](#) on average.

Expected portfolio returns on the rich country stock, bond and private markets that comprise more than 80% of the average institutional investor portfolio are significantly lower than the outsized 6%–8% of yore, only around 3% as estimated by the [Norwegian Oil Fund](#), for example. Others are more pessimistic about GMO, the asset management firm run by Jeremy Grantham, a legendary investor, expecting mid-term [returns to fall](#) into negative territory. Both expect developing economies to do significantly better for the foreseeable future.

Diversification is the only free lunch in investment and investors are going hungry

Harry Markowitz, regarded by many as the father of modern finance, is reported to have said that “[diversification is the only free lunch in finance](#)”. Whether he really said it or not is less important than the fact that his work, for which he was awarded the Nobel Prize in economics, showed this to be the case. An acolyte of Markowitz, William Sharpe, developed this insight further to launch the [capital asset pricing model](#) (CAPM), the mainstay of modern finance and was also awarded the Nobel prize in economics for his work.

Prior to the seminal work of Markowitz and Sharpe, investors mostly targeted assets that they thought would generate the highest returns. They showed the superiority of [investing across multiple assets](#) that were less than perfectly correlated, for example they would not all do equally well, or equally badly at the same time. They showed that doing so would generate superior returns for any expected level of risk taken by the investor.

This was also the birth of a portfolio approach to investing, which did not make investment decisions solely or even primarily by looking at the prospective returns or riskiness of a particular asset under consideration, but by evaluating how

adding that asset to one's existing portfolio of investments would affect the expected returns and risks of the overall portfolio. This is the approach followed, at least in theory, by most, if not all modern finance, especially by [institutional](#) (rather than) retail investors.

A somewhat counter-intuitive result of this portfolio-based approach to investment is that an attractive investment offering high expected returns for limited risk may be rejected even as a relatively less attractive (on a standalone basis) investment that offers more modest returns for higher risk may be accepted as long as the distribution of expected risk-return outcomes of the latter asset improves the risk-return outcomes of the whole portfolio by having a low correlation with the existing portfolio. This is how the, sometimes counterintuitive, [magic of diversification](#) works.

These diversification benefits are exactly why the 60/40 portfolio, broadly a mix of about 60% of equity (or equity-like assets) and 40% fixed-income assets, especially bonds, remains the tried and tested starting point for [strategic asset allocation](#) for almost all institutional investors. An income-maximising portfolio would only focus on equities that have been shown to outperform bonds over the long term, but adding bonds and fixed-income assets, which are often negatively correlated to stocks, increases expected return for any given level of risk, even as it [reduces](#) expected portfolio returns. Sharpe's work popularised the idea of a [market portfolio](#), comprised not just of stocks and bonds, but of all investable assets, at least in theory.

[Researchers](#) from the asset management industry and Erasmus University have recently tested the idea again and show that a market portfolio comprising of all investable assets, including those in developing economies, real estate and other illiquid assets has offered the best returns for the risk taken, and has minimised the risk, size and duration of drawdowns, often a more appropriate measure of risk for institutional investors than the more commonly used measure of short term volatility. This reinforces [the work we have done](#) before advocating for large 'universal' investors to invest in the universal portfolio of all geographies and all asset classes, including unlisted infrastructure in frontier markets, for example.

Such a portfolio shows the benefits of more diversification over the narrower approaches used by most rich country institutional investors who often restrict

themselves to rich country assets, and underweight, or [altogether ignore](#) other investment opportunities, for instance in developing countries, often at a [significant cost](#) to themselves, as we have shown in detailed analytical work on the investment strategy and [performance](#) of Norway's sovereign wealth fund.

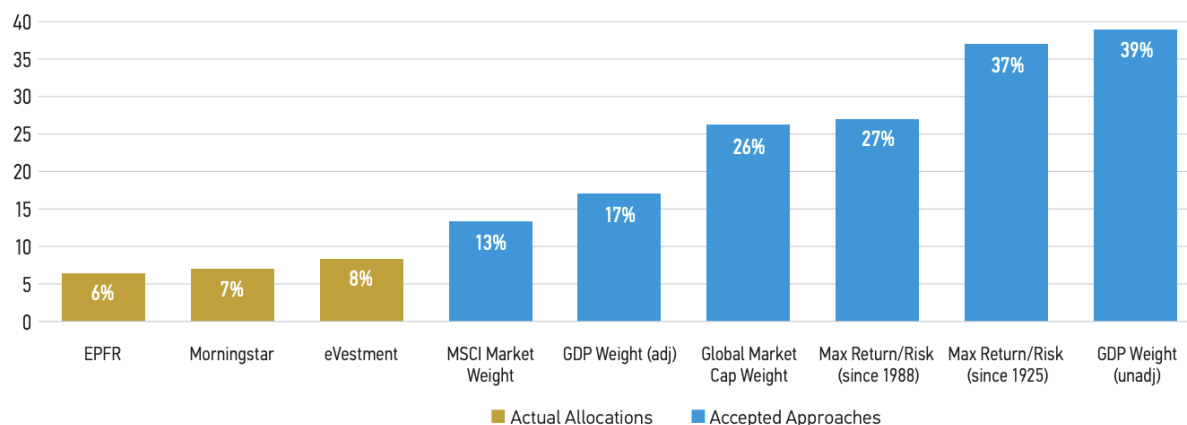
As global GDP, innovations and economic growth shift away from rich economies towards developing countries, the cost in foregone returns and higher risk of rich country institutional investors continuing to invest most of their assets (between 80% and 100%) at home and in other rich economies will continue to rise and rise and further undermine an already fragile pension system in the west. Whether demographically, culturally, politically, or in terms of the underlying structure of their economies, developing countries differ substantially from rich economies and from each other offering [true structural diversification opportunities](#) for institutional investors, even when returns may not look so attractive despite their faster growth rates. This is true of both listed and [unlisted opportunities](#).

It is worth quoting an analysis from [Morgan Stanley](#), an investment bank, directly here.

"The broad paradox of savvy global investors shunning markets that are far from home is very likely to grow over time. As emerging markets continue to gain share in global GDP and global market cap, and to advance in financial depth and sophistication, they will continue to be increasingly attractive, based on the most important allocation models. This gap, between opportunity and allocation, seems to us especially acute today, when an emerging market comeback has already begun, and the economic fundamentals suggest many reasons to believe that it could last.

To those wondering where EM growth will come from, the possibilities begin with manufacturing, commodity prices, economic reforms, and the rise of major new internet service industries and companies outside China. In general, we think the logical answer to 'how much' to invest in emerging markets is more. For a host of fundamental and structural reasons, that answer has rarely been truer than it is right now."

Figure 7: Optimal vs. Actual Allocations to EM Equities (%).

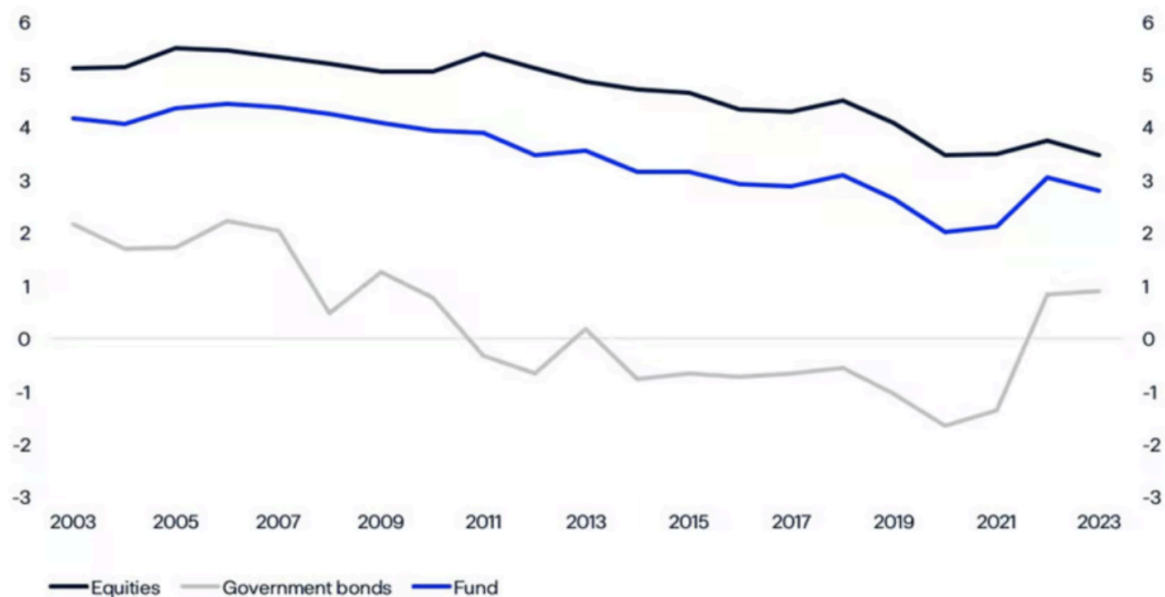


Source: [Morgan Stanley](#)

Morgan Stanley could not be clearer in its analysis and recommendations that institutional investors should allocate much more to developing economies. There are legitimate differences in approaches to how much they should allocate, but even the lowest defensible allocation is at least double of the current levels, with a forward-looking GDP-linked allocation as much as 5 times higher, or as much as 40% of the total. While these numbers are for listed equities, the same logic applies to fixed income, private equity, and other unlisted assets such as infrastructure. Our own recommendation to Norway's Oil Fund in 2008 was a minimum of 20% allocation to developing economies, including in unlisted assets and infrastructure, especially [renewable energy, rising gradually](#) to 40% over two decades, roughly in line with Morgan Stanley's more recent 2021 recommendation.

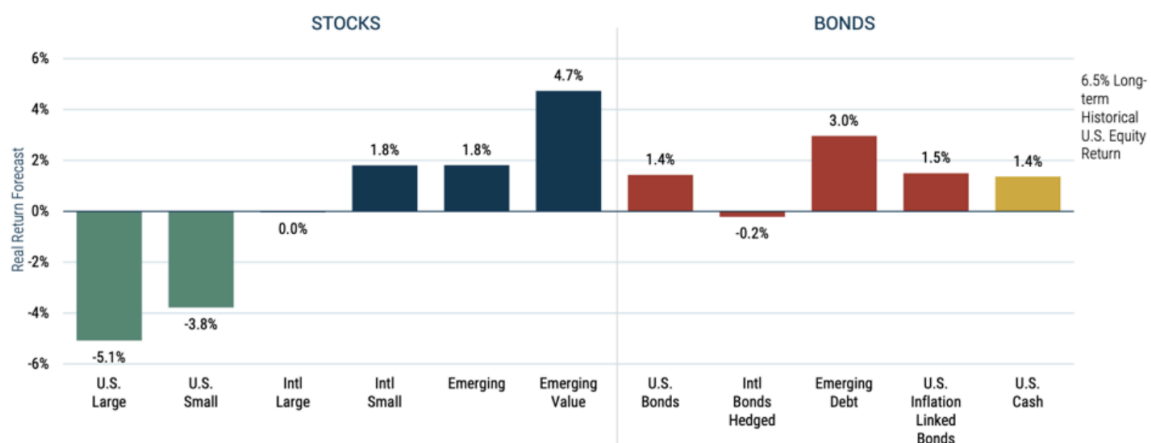
Even those asset managers who are less pessimistic about the prospects for returns on rich country financial assets, such as [JP Morgan](#), [Nuveen](#) and [Robeco](#), expect developing country assets, including stocks and bonds to outperform their rich country counterparts over the medium to long term.

Figure 8: Expected real returns on the fund's benchmark and key asset classes, in percent.



Source: [NBIM](#)

Figure 9: Seven-year asset class real return forecasts, as of July 31, 2024.



Source: [GMO](#)

If returns fall significantly from outsized historical levels, it will precipitate a [huge pensions, insurance and funding crisis](#) in the rich world. Even after record-breaking financial market performances, US public pension fund schemes are underfunded with more than a [\\$1 trillion deficit](#) and while they have gradually reduced the forward-looking return assumptions down from 8% in 2001 to about 7% now, this modest revision downward simply does not comport with the far

more modest returns everyone from NBIM to the US Federal Reserve foresees. If returns fall much below this unrealistically high expected return, as is likely given the [poor growth prospects](#) of developed markets, we will see new stress and even a crisis in [pensions](#) and [insurance firms](#) in [developed economies](#).

In conclusion

To maintain the higher returns they need, there is a clear and compelling [return maximising reason](#) for rich country institutional investors to significantly expand their asset allocations to higher yielding developing country assets. This includes not just listed stocks and bonds, but also illiquid private equity and infrastructure investments, which are all expected to generate [significantly higher returns](#) in the mid to long term driven by the fundamental economic factors of favourable demographics and catch-up growth.

An equally compelling reason for significantly expanding investments in developing economies is to diversify away some of the excessive risk portfolios invested primarily in rich economies facing the structural headwinds of poor demographics and poor productivity growth prospects. Only developing economies can offer the true structural diversification necessary to robustly reduce the long-term risks faced by institutional investors.

The new perspectives offered in this short paper call for a reset of the approaches that advocates of billions-to-trillions and mobilisation of institutional investors for SDG and climate investments in developing economies have taken. Much more emphasis needs to be put on making and winning the ‘first order’ arguments on the risk-return imperative for rich country institutional investors to dramatically shift their portfolios towards developing economies, something the community has failed to do so far. Without this, the speed and scale of investments needed will never materialise.

This does not mean that the current ‘second order’ approach of making the ethical, moral and impact case for developing country investments and using the carrots of blending and subsidies to bring the horse to drink should be discarded. Far from it. These are important arguments to make and win. But putting most of our efforts into these second-order arguments, while neglecting to make and win

the first-order arguments is doomed to fail. As we have [shown elsewhere](#), there is also an important role for blending, including subsidies, but the excessive focus on these alone risks undermining, rather than boosting mobilisation efforts.

Subsidising investor education, in a world where most Western institutional investors and policymakers still fail the [Hans Rosling test](#) of ignorance about the state of the world, wrongly thinking that Bangladesh has a birth rate of five, rather than two, is a necessary first step. If this is how little our financial and policy elite know about Bangladesh, a dynamic country of 170 million people that has seen an average annual growth rate of 7% over the past decade, how can we expect them to invest at scale in the many smaller economies of Sub-Saharan Africa that have registered lower growth rates?

Building capacity and expertise about the world outside the EU and US in supervisory boards, investment committees, regulators, finance ministries, politicians and the broad investment and policy community is critical. Adapting the regulatory framework to remove institutional investors' investment barriers and provide the right set of incentives (e.g., green/development fiscal incentives) is a second necessary step. Approaching this issue should be done at the international level, and the fourth financing for development conference could be an opportunity to make progress on this issue.

Blending facilities, particularly those that involve co-investments alongside Development Finance Institutions and Multilateral Development Banks are promising and have the potential to be catalytic, and [we have advocated](#) for those for over 15 years. Subsidies can play an important role when used wisely for demonstration initiatives, market creation, capacity development, pooling vehicles, and in the specific context of fragile and conflict states and some low-income economies.

But these should be used very sparingly, and only as a last resort as anything that needs subsidising is almost never scalable, at least for a long time. [As a rule](#), subsidies, and other blending facilities such as guarantees, should be limited, temporary, priced fairly by professionals, embed a clear exit strategy and should only be used with a strong up-front development or climate justification. Finally, blending facilities are also useful in accelerating the speed at which institutional

investors move towards developing economies and time is of the essence in the climate crisis.

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