

## **Aligning Blended Finance Investments with Asset Owner (AO) Requirements**

*This research note was written under the auspices of the Blended Finance Lab the London School of Economics and Political Science (LSE).*

*The Blended Finance Lab is a practitioner-driven initiative focused on developing practical solutions to scale blended finance. It brings together investors, policymakers, development banks, NGOs and academics to strengthen the blended finance community, enhance practices and education, and generate more investable opportunities.*

*The Lab was launched in March of 2025 and in early discussions with involved stakeholder groups we identified the need for the blended finance community to develop a better understanding of how asset owners such as pension funds and insurers make capital allocation decisions. The Lab engaged Jeroen Zuurmond, independent adviser with extensive investment management and capital markets experience, to research this issue and document his findings.*

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Research question: What does the broader Blended Finance (BF) ecosystem need to know and need to do to create investments that are more likely to fit with existing Asset Owner (AO) requirements?

This paper is based on a combination of desk research and a select number of brief interviews with practitioners working for or advising large AOs.

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### **1. Understanding Asset Owner Criteria**

How do large AOs (in particular: pension funds, insurance companies, endowments) typically determine asset allocation and how do they set risk, return and other criteria?

Asset allocation processes and methodologies are used by Asset Owners to balance long-term growth with risk management, while meeting obligations (pensions and insurance) or

funding commitments (endowments). Insurance companies' methodologies differ from pension and endowments mainly due to regulatory reasons (especially Solvency frameworks) and liability structures. Insurance portfolios are more bond-heavy, conservative, and regulation-driven. Pension funds balance between growth assets and liability hedging. Endowments maximise return per unit of risk, with heavy alternative exposure. The methodology typically involves a set of standard high-level asset classes such as equities, bonds, real estate, and alternative investments.

#### Typical Example Strategic Asset Allocations by AO Type

| Asset Class  | Endowments | Pensions  | Insurance |
|--------------|------------|-----------|-----------|
| Equities     | 40% - 60%  | 40% - 60% | 20% - 30% |
| Bonds        | 10% - 20%  | 30% - 50% | 40% - 50% |
| Real Assets  | 10% - 20%  | 5% - 15%  | 5% - 10%  |
| Alternatives | 20% - 40%  | 5% - 10%  | 10% - 20% |

#### Asset Allocation Features by AO Type

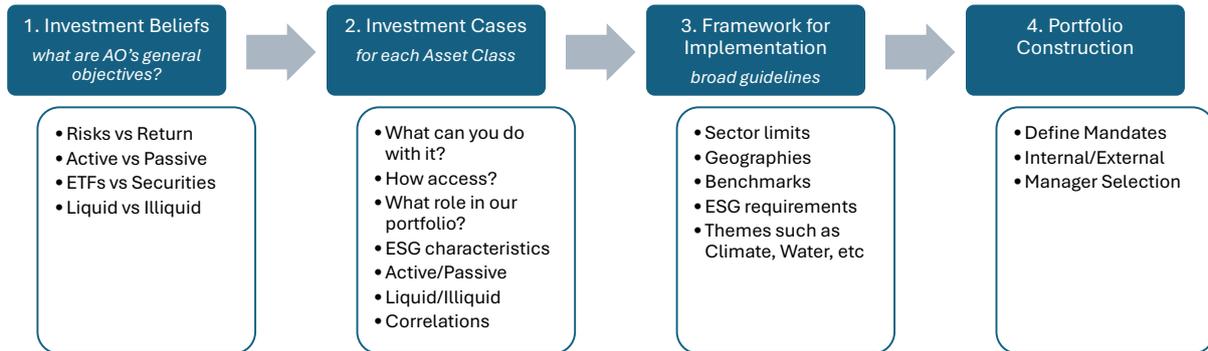
| Feature                     | Endowments                                      | Pensions                                 | Insurance  |
|-----------------------------|---|--|--|
| <b>Primary Goal</b>         | Grow capital in perpetuity, fund spending       | Match liabilities (retirement payments)  | Meet claims obligations, regulatory capital efficiency |
| <b>Time Horizon</b>         | Very long-term (perpetual)                      | Long-term, multi-decade                  | Life insurers: long; Property & Casualty: shorter      |
| <b>Dominant Asset Class</b> | Alternatives (PE, VC, hedge funds, real assets) | Equities & Bonds (mix varies by funding) | Fixed Income (IG bonds, mortgages)                     |
| <b>Role of Alternatives</b> | Core driver of alpha & illiquidity premium      | Return enhancement, diversification      | Limited, used if capital-efficient                     |
| <b>Constraints</b>          | Spending policy, liquidity                      | ALM, funded status                       | Regulatory capital, accounting treatment               |

Although terminologies differ, the highest level of asset allocation is typically referred to as the Strategic Asset Allocation (SAA). The process of determining or updating an SAA involves setting long-term target allocations based on risk tolerance, liabilities and return objectives. These are set at the highest AO governance level. The SAA is usually reviewed periodically (e.g. annually) to adjust to changing market conditions, but it is generally a stable, long-term approach. The resulting allocation bands are very broad and do not prescribe detailed portfolios. The construction of the portfolio is typically left to the office of the chief investment officer (CIO).

Several methodologies exist to determine or update an SAA, using tools such as asset-liability matching (ALM) models. ALM models and other elements of the process to determine or update the SAA may be outsourced to specialist advisory firms.

Based on respondents' inputs, the following schematic depicts a sample process to determine and implement an SAA:

## Sample Process to Determine and Implement Asset Allocation



1. The first step is to agree or update the *investment beliefs* of the AO, answering questions about its general objectives and potential investment portfolio characteristics.
2. Second is to develop or update the individual *investment cases* for all asset classes under consideration.
3. The third step brings everything together in the *framework for implementation*, setting the broad parameters for implementing the SAA in the investment portfolio.
4. This framework is used in *portfolio construction*, typically overseen by the CIO office, which is the process of defining mandates to be invested by internal groups or delegated to external managers.

When asked at what point in the process potential themes such as Climate, SDGs or Impact Investments could be introduced or discussed, respondents agreed that this varied by AO, but certainly after the high-level asset classes have been set. Thematic considerations could feature during or even only after step 3 (framework for implementation).

Most respondents found that Blended Finance as such typically won't feature in an SAA, because (a) the SAA only considers more traditional asset classes, (b) BF is a very broad concept and does not have unifying characteristics that may define an asset class, and (c) the SAA is set at a very high level. When BF does feature in AO portfolios, this seems to be more opportunistic within certain specialist mandates that were defined in the Portfolio Construction phase, for example in climate related funds or infrastructure mandates.

Critical inputs and assumptions underpinning a typical SAA process are as follows (Slager & Vos, 2023):

1. **Return Expectations:** Estimates of the expected return for each asset class (equities, bonds, real estate, etc.) over the investment horizon. These expectations are typically based on historical performance, economic forecasts, and market outlooks.
2. **Risk Tolerance:** boards need to assess their risk tolerance, which determines the degree of volatility they are willing to accept in their portfolio. This is often influenced by the nature of the liabilities (e.g., the cash flow needs and the duration of its obligations).
3. **Liabilities** (cash flow projections): Understanding the timing and magnitude of future liabilities is essential for determining how much risk the AO can afford to take. A board must factor in the size and timing of the liabilities to match the assets accordingly.
4. **Inflation Expectations:** Since AOs may have long-term horizons, inflation plays a significant role in both the real return of investments and the future value of liabilities.

Inflation-linked bonds and other inflation-protected assets are commonly used to hedge against inflation risk.

5. **Correlation Between Asset Classes:** Understanding how different asset classes move relative to one another is key to creating a diversified portfolio that reduces risk. AOs need to assess the correlations between various assets to avoid concentration in any one risk factor.
6. **Regulatory and Legal Constraints:** AOs may be subject to various regulatory frameworks and legal constraints. These must be considered when setting asset allocation, especially in the context of limits on exposure to certain asset classes or investment vehicles.
7. **Liquidity Needs:** Depending on the AO's structure, there may be a need to maintain a certain level of liquidity to meet short-term liabilities. Liquidity constraints can influence the selection of more liquid, lower-yielding assets versus illiquid, higher-yielding ones.

## 2. Relevant Allocations for Blended Finance

Which allocations would most closely align with the type of investments that are typically structured using BF tools (e.g., emerging markets (EM), infrastructure, alternatives) and what requirements generally need to be satisfied to be considered for those allocations (e.g., ratings)?

Asset allocations mentioned by respondents most closely aligning with blended finance were:

- Private Market Debt
- Structured Finance
- Infrastructure Debt & Equity
- Emerging Markets Debt
- Impact Investments

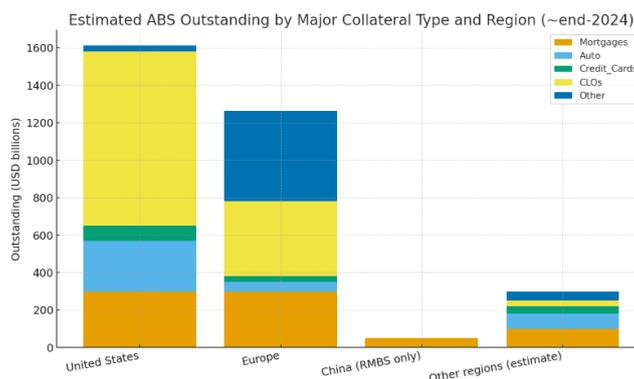
### *Private Market Debt*

Private market debt allocations have seen high growth over the past decade and this category is now seen by most AOs as an asset class. Although terms and definitions vary, there are many different types of lending strategies and target markets: loans to large leveraged buyouts (LBOs), mid-market LBOs, direct lending to companies, venture debt, trade finance, asset based finance, real estate lending, etc.. Private debt typically encompasses private loan strategies where the manager of the strategy arranges the loans and no banks are involved. It is typically seen as a developed market-only asset class, and hence emerging market loans are typically not seen as part of this asset class. Large AOs are interested in investing in private debt because of the pick-up in yield that is typically offered, but in exchange for less liquidity.

### *Structured Finance*

The Asset Backed Securities (ABS) market size is estimated at USD1.6 trillion in the US and USD 1.2 trillion of outstanding ABS in Europe, both mostly made up of mortgages and collateralized loan obligations (CLOs). Especially the latter is encouraging in the context of this research, as BF may be able to utilize existing CLO technology and approaches to access these markets, where bond investors are looking for a yield premium. The technology and

regulatory status of these instruments have improved dramatically since the Great Financial Crisis.



Source: ChatGPT estimates using various sources such as the US Fed and AFME.

Could structured finance technology be used to create large, liquid, rated and tranching programs with junior, mezzanine and senior tranches in certain situations where the underlying collateral allows this? This is an open question but if so, it would bode well for the possibility for AOs to allocate to BF vehicles.

### *Infrastructure Debt & Equity*

Private investments in infrastructure are sizeable markets. These involve public-private partnership structures, where government institutions assume the risks private investors cannot. These investments are typically managed by specialist asset managers on behalf of large AOs, who require these long-dated investments. There are several examples of BF strategies that have used these kinds of structures and that have found success in obtaining AO allocations.

### *Emerging Markets Debt (EMD)*

Most respondents associated BF with emerging markets. Although the EMD asset class is widely allocated to, it mainly consists of bonds issued by sovereign or semi-sovereign institutions or very large corporations. These are relatively large bond issues typically priced and traded on the basis of their own credit ratings and geographies. For BF to fit within this asset class would require an attractive credit rating (i.e., investment-grade BBB or higher) coupled with an active over-the-counter market in the bonds. There are some EM investors with large enough portfolios to seek diversification by adding private debt in EM through specialist managers.

### *Impact Investing*

Many respondents also associated BF with impact investing, which is increasingly prevalent as an investment theme. As with BF, impact investments are not seen as an asset class, but more akin to an investment theme to be incorporated during or after Step 3 in the AO implementation framework discussed in section 1 above. Many also felt that impact cannot be expressed in listed equities or bonds but would require private market allocations. One respondent mentioned that an impact investment objective had motivated the pension fund in question to require 50-60% of its new Private Debt allocation to have explicit impact objectives.

### **3. Attractive Features of Blended Finance**

Which benefits can BF investments offer that would make them attractive to AOs and how this can be better showcased?

Respondents mentioned several benefits of BF investments:

- *Ability to address very specific investment themes otherwise difficult to access.*

For example, the manager of a biodiversity fund-of-funds mentioned they invested in a nature-based solutions fund, where BF was used to create bond-like investments with current yield in wildlife programs in Africa. The coupon is paid by donors and the principal payment is linked to performance criteria and supported by a subordinated (equity-like) tranche provided by a Western European development bank. They consider the robustness of the subordination provided to be a significant vote of confidence that reduces risk while the current yield is very welcome within a strategy where many investments produce dividends much at a much later stage or even only upon exit.

- *Demonstrate engagement with stakeholder preferences or government policies*

AOs may be sensitive to societal trends or feedback from stakeholders (such as beneficiaries) and may therefore wish to demonstrate alignment to these trends by participating in government sponsored programs, which could entail BF structures.

- *Portfolio diversification*

AOs constantly evaluate the risk in their portfolios and look for ways to make their portfolios more robust, which typically involves diversification, a proven risk mitigation strategy. Respondents endorsed this specific benefit, but provided it is supported by correlation data or other strong evidence. In addition, it is more likely that an AO will invest if they have existing exposure which they can build on in terms of their own expertise or experience and the new exposure is comparable to or an expansion of existing allocations.

### **4. System-Level Motivations**

Are system-level motivations such as "addressing climate change" viewed as compelling by AOs and do they drive increased interest in BF?

All respondents confirmed that investment themes can ultimately play an important role in the implementation part of the asset allocation process. This could be for various reasons, including: (i) demonstrating to (surveyed) stakeholders such as beneficiaries that trustees are responding to their views; (ii) political pressure; (iii) following market trends; (iv) trustee/board preferences.

One of the issues highlighted regarding these investment themes (impact, water, social health, Sustainable Development Goals (SDGs), etc.) is that of the AO being able to *measure* the results – both the (potential) impact of the issue on the portfolio and the impact that the AO has on the theme in the real world.

One respondent, a member of the investment advisory board of a large AO, described how this organization sets investment themes at board level and then fully delegates the implementation to the CIO and portfolio managers within the existing frameworks. This means that the frameworks (with allocation bands and financial performance benchmarks)

are still the first priority, with the investment themes only being considered as secondary, in the portfolio construction phase. However, the target allocations to investment themes are still being monitored and often end up on the website as a primary communication tool.

A number of respondents mentioned that investment themes such as climate and SDGs can only effectively be addressed in the Private Markets. Although not the primary driver of the trend towards more illiquid private markets, it does seem to reinforce that trend (“impact/systemic risk themes motivate AOs to allocate to illiquid”).

In sum, while many AOs have embraced impact themes and discuss the need to understand and manage systemic risks such as climate change, this does not (yet) appear to have resulted in an increased interest in BF investing.

## **5. Actions for Closer Alignment**

Which actions could be taken, by governments, development banks, asset managers or other stakeholders to make BF investments more closely aligned with conventional AO requirements?

One respondent suggested that producing position papers discussing the characteristics and potential benefits of BF and disseminating them to AOs (through investment advisors, asset managers, or academic channels) might help them to objectively determine its place within or among the various asset classes.

## **6. Conclusion**

Findings:

- AOs are receptive to the idea of BF, but do not see it as an investment theme or asset class.
- BF does not feature in the SAA, but some BF investments do find a way into the portfolio if they meet the criteria set for the relevant asset class, for manager selection, etc..
- BF is associated most with Impact Investing or Private Market Debt.
- BF can benefit from the AO trend of allocating to illiquid markets.

The growing market for BF investments would benefit from further (academic) research; a few themes are listed below. These are areas where the Blended Finance Lab might be able to contribute.

1. Develop ‘Investment Cases’ for the different types of BF structures, specifically geared to AOs: “What can BF do for your portfolio?” This could be undertaken for BF Funds, special purpose vehicles, securitizations, infrastructure project financings, private equity, venture equity/debt, trade finance, etc.
2. Map the BF Investment Cases to existing and future mandates in AO portfolios to identify where they could fit.
3. Map the BF structures to nascent and growing market demand for sustainability-linked instruments.
4. What would it take to access the global ABS market?

## References

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