

Creating resilient pension portfolios post Covid-19

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Foreword

Covid-19 is the perfect storm for the long-awaited revival of mean reversion in investing, sidelined in a prolonged era of artificially high asset prices inflated by the ultra-loose monetary policies and low inflation of the last decade.

As this report shows, the latest exceptional policy response to the crisis in the West will come with its own unintended consequences in areas as diverse as mounting global debt, rising inflation and the de-globalisation of supply chains.

As they materialise, we may well witness the reversal of a long process that has, over time, turned investment returns into a monetary phenomenon; influenced far more by central bank action than by the state of the real economy – contrary to all tenets of investing.

It all started with the so-called Greenspan 'put'. During Alan Greenspan's chairmanship, the US Federal Reserve reduced its fund rates and added liquidity to encourage risk-taking to avert further deterioration in times of market stress.

The most striking occasions were the 1987 stock market crash, the Asian crisis, the LTCM crisis, the bursting of the internet bubble, the 9/11 attacks and the 2008 global financial crisis. The perception that the Fed would always intervene if markets tumbled has long been ingrained in investor psyche.

The question now is whether the Fed's Midas touch will wane with its latest policy overreach?

This report highlights the current twist in a dynamic that will likely ensure that financial markets are forced to learn to stand on their own two feet as this decade progresses. In the process, portfolio resilience will be the new guiding star for pension investors.

Amundi Asset Management is grateful to Amin Rajan for helping to uncover the latest thinking behind the asset allocation choices of pension investors worldwide as they plan for the post-pandemic era. We hope that you will find his analysis insightful and useful.



Pascal Blanqué

Group Chief Investment Officer
Amundi Asset Management

Acknowledgements

*"The central bank is neither God nor a magician
who can turn uncertainties into certainties."*

Zhou Xiaochuan, former Governor of People's Bank of China

This cautionary reminder from on high has found ready resonance among pension investors worldwide, as they survey the carnage inflicted on their balance sheets by the devastating coronavirus crisis. But, alas, the matter does not end there.

While welcoming the immediate and unprecedented stimulus by central banks and their governments in all the key economies, there is now ample recognition that it comes with downside risks that are too big to ignore.

This survey is the latest in the annual Amundi–CREATE series started in 2014. It presents a detailed assessment of how pension investors are rejigging their asset allocation to cope with the unintended side effects of the unusual policy intervention.

My special thanks go to 158 pension plans in 17 jurisdictions who participated in the survey to provide insights into how they see the crisis evolving from here on and what actions are being taken to ensure their own solvency in this surreal crisis.

Over the years, many of our respondents have helped to highlight how the pension landscape has been changing and thereby creating an impartial research platform that is widely used in all pension markets.

I would also like to thank Amundi Asset Management for sponsoring the publication of this report without influencing its findings in any way. Their arms-length support has improved the credibility of this series as it has gone from strength to strength.

My grateful thanks also go to IPE for carrying out the survey each year for us and to its editor Liam Kennedy for his inspirational guidance and support.

Finally, I owe a heavy debt to three colleagues: Lisa Terrett for managing the survey and data analysis, Anna Godden for managing the desk research and interview programme, and Dr Elizabeth Goodhew for her excellent editorial input.

If, after all this help and support, there are errors or omissions in this survey report, I am solely responsible.



Amin Rajan

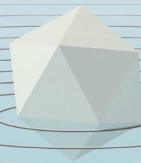
Project Leader
CREATE-Research

Contents

Foreword	i
Acknowledgements	ii
1 — Executive summary	1
Introduction and aims	2
Survey highlights	3
Headline findings	4
Theme 1: There is no single story to tell about Covid-19	6
Theme 2: Initial deflation might morph into stagflation over time	7
Theme 3: Asset prices will most likely reconnect with their fair value	8
Theme 4: Portfolio resilience has raced up the pension agenda	9
Theme 5: The pandemic has supercharged sustainable investing	10
Theme 6: Equities will remain the engine of capital growth	11
Theme 7: Covid-19 could be the last straw for many DB plans	12
2 — Asset allocation in the age of uncertainty	13
What will be new and what will be different?	
Overview	14
Investing will focus on firms that can weather the storm	15
Asset allocation will pursue multiple goals	17
Focus on resilience will be turbocharging theme investing	19
Index investing will tilt towards themes as it grows	21
3 — Rise of goals-oriented investing	23
Which asset classes will be favoured?	
Overview	24
Equities will remain a bright spot on relative valuation	25
Known risks are overpowered by unknowable uncertainties	27
Market fragility is creating tailwinds for long-term investing	29
4 — ESG: the cornerstone of investing	31
What is the scorecard so far?	
Overview	32
The pandemic has hastened the tectonic shift towards ESG	33
ESG is about pricing the future into the present	35
The success of ESG rests on a 'just transition'	37

1

Executive summary



Introduction and aims

Covid-19 is a 'once in a hundred years' cataclysmic event. Superlatives that do it justice are hard to find.

The emotional, physical and economic pain it has inflicted is the worst in living memory. After the most precipitous economic destruction, it is hard to know whether the global economy will snap back to its pre-crisis path or suffer permanent scars.

Such a calamity can never truly be resolved until many of the fundamentals of our social and economic lives have been repaired. After all, history shows that humanity has always emerged from tumultuous upheavals mostly the stronger for it, but not without heavy cost.

Thus, investors are left to grapple with four big unknowns: how long successive lockdowns of 2020 will last, how long national economies will take to recover, whether their productive base will emerge intact, and what the successful business models will be when the worst is over?

The pandemic has caused unusual tremors, with demand, supply and finance at their epicentre. With radical uncertainty, the normal business cycle dynamics have been sidelined.

Governments and their central banks have duly embarked on a 'whatever it takes' wartime-type response to save lives and protect livelihoods, sparking a dramatic policy revolution in real time, reacting as specific needs have arisen. It marks the passing of an *ancien régime*.

As history shows, such upheavals accelerate deep-rooted existing trends while also unleashing new secular forces via innovation. Their long-term impacts on financial markets are hard to spot at the time; by their very nature, they only become evident in hindsight.

Investors are thus left to decide whether the current volatility in asset prices is a buying opportunity or the halfway stage in a prolonged bear market.

Hence, our 2020 annual Amundi-CREATE survey aims to shed light on how pension plans worldwide are responding as the world economy struggles to recover from what is the economic equivalent of a massive cardiac arrest. Taking a 3–5 year forward view, the survey aims to obtain their views on three core issues:

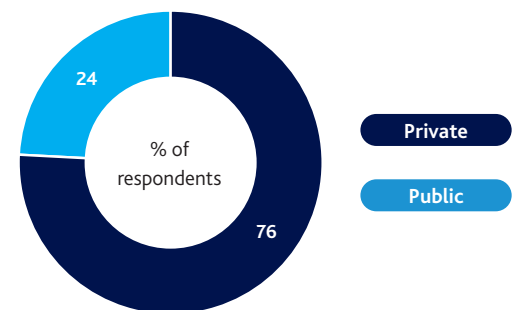
- what shifts are likely in the current macro financial regime in response to the unorthodox policy response?
- how will these shifts affect the way investing is done in future?
- what will be the key changes in pension plans' asset allocation?

The survey is based on 158 respondents from 17 pension markets, collectively managing €1.96 trillion of assets. Their background details are given in Figure 1.0. The survey was followed up by structured interviews with 30 senior decision makers in the respondent organisations. The survey provided the breadth, the interviews the insights.

The rest of this section provides the survey highlights, their three key findings and their seven associated themes.

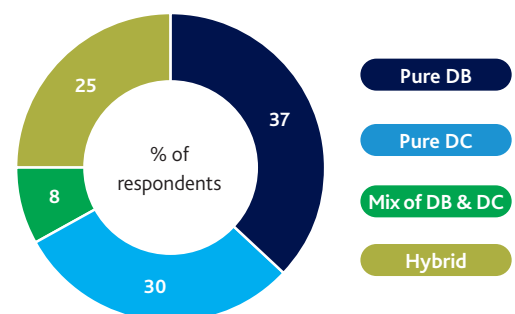
Figure 1.0 Pension plan respondents

What sector does your pension plan cover?



Source: Amundi Asset Management/CREATE-Research Survey 2020

What is the nature of your plan?



Source: Amundi Asset Management/CREATE-Research Survey 2020

"The times they are a-changing."

Bob Dylan

Survey highlights

(% of pension plan respondents)

Anticipating the likely fallout from Covid-19

84%



Key central banks are likely to lose their independence from their governments

77%



Inflation is likely to follow deflation once the current crisis is over

85%



Financial markets will experience either a W-shaped or an accordion-shaped recovery

90%



Asset returns will be lower in this decade compared with the last one

Accepting that central banks may lose their potency

81%



Central banks are likely to lose their potency in artificially affecting asset prices and their volatility

77%



Asset prices are likely to reconnect with their fundamental value

67%



Covid-19 is likely to mark a turning point in how investing is done as resilience tops the investor agenda

57%



Liquidity management will become the third pillar of asset allocation after risk and return

Building resilient portfolios

75%



Private markets will be targeted to achieve custom-built resilience via investment covenants

58%



Thematic investing will be targeted to achieve inherent resilience via secular global growth points

76%



High-quality cash flow compounders among global equities will top the asset allocation choice

61%



Forward-looking scenario planning will buttress the conventional risk models

Making finance a force for good

80%



ESG funds have gone mainstream, accounting for more than 20% of total pension assets

61%



Target good risk-adjusted returns from their ESG portfolios

52%



ESG funds performed better than the rest of the portfolio during the market crash in March 2020

82%



Expect to increase the ESG share in their total portfolio, so as to cater for fat-tail/far-off risks

Headline findings

1. Covid-19 has wrecked pension finances

The extraordinary policy response by central banks and their governments was timely and vital. But it has also inflicted toxic side effects on pension solvency via ballooning liabilities and plunging incomes from zero-bound interest rates. Alongside the market meltdown in March 2020, these have ravaged funding ratios worldwide.

Plan sponsors are now being asked to make big cash injections just when their own finances are taking big hits. They are seeking to downsize pension benefits and improve portfolio returns. That is easier said than done.

In asset allocation, assessing the macroeconomic damage of Covid-19 has been akin to looking through a kaleidoscope: different images have appeared with every turn of the dial. Yet, in the ensuing narratives, the longer the pandemic lasts, the greater the economic damage.

Pension plans are thus forced to rely on various scenarios over this decade. They factor in one or more of the following:

- After their collapse in March 2020, financial markets will likely have a W-shaped or an accordion-shaped recovery: both highly volatile by nature. The scale of permanent economic scarring of the global economy will be the deciding factor.
- Many key economies are likely to switch from an era of wealth creation to one of wealth distribution. Unusual policy support for businesses will come with strings attached.
- The greatest central bank–governmental intervention of all time in the West will witness a de facto merger of their balance sheets to stave off a 1929-style Depression. Control of inflation may pass from central banks to governments.
- Inflation expectations risk being unanchored and emerge as a distinct driver of rising prices in their own right, pushing inflation to levels not seen since the 1970s. Two factors will tie central banks' hands: high debt levels and yield curve control.

"Inflation is a sleeping giant rather than a slain dragon."

An interview quote

- It is also hard to see how the US Federal Reserve can step back from its latest purchases of downgraded private debt without sparking a backlash. The 'taper tantrum' of 2013 provides a foretaste of what beckons once the genie is out of the bottle.

Thus, scenario planning is now factoring in three potential outcomes:

- moral hazard, as governments have been forced to take massive risks with their extraordinary stimulus without much regard to medium-term unintended consequences
- rising prices, from an unholy mix of excess spending, a scarred economy, redistributive policies that lift worker incomes, and deglobalisation that lifts industrial costs
- volatility spikes, as central bank action risks a serious overreach that could roil markets from time to time.

[Themes 1, 2 and 3](#) provide further details.

2. Investing is now reduced to a single imperative: antifragility

A razor-sharp focus on resilience has been the immediate reaction, as known risks are overpowered by unknowable uncertainties. This is evidenced by a tug of war between opposing forces: on the bull side, rocketing equity markets due to central bank support; on the bear side, deteriorating fundamentals in the real economy, as the pandemic has since entered a second wave. In the dark, all swans could be black. Hence, asset allocation will have two additional pillars.

One is liquidity. This allows bargain hunting during periodic market dislocations, while avoiding a liquidity trap if the outlook worsens. Like asset diversification, liquidity seems to vanish when it is needed most. Unlike other risks, it cannot be diversified away.

The other pillar is resilience. This ensures that investing is on the side of change by factoring the post-pandemic future into the present. It means targeting assets with policy backstops or inbuilt shock absorbers or both. This implies selecting firms that can weather the storm and emerge stronger on the other side.

Hence, asset prices are likely to reconnect with their fair value, as central banks' role in artificially inflating asset prices and controlling volatility crosses the point of diminishing returns.

Previous rounds of quantitative easing have brought forward future returns in an environment of anaemic global growth. In the prospective low-return environment, asset allocation will selectively target four goals. They and their supporting asset classes are:

- *capital growth*: global equities, EM equities, high-quality equities
- *income generation*: infrastructure, IG bonds and alternative credit
- *inflation protection*: equities and infrastructure
- *asset conservation*: sovereign bonds.

These goals will reinforce the alpha-beta separation, as fees become a key source of returns. They also imply that equities will retain their gravitation pull. Finally, passive funds will continue their ascent by tilting towards mega trends.

Themes 4 and 6 provide further details.

3. ESG funds are going from virtue signalling to value signalling

Theme investing will be turbocharged by mega trends that define secular growth points in the global economy like technology, healthcare and climate change. By disrupting industries, they are singling out the more predictable sources of value creation.

The pandemic has vividly shown how physical shocks – unlike economic ones – can roil the markets and whipsaw pension portfolios in ways previously unimaginable. Investors now have a foretaste of some of the old 'unknown unknown' impacts of climate change and societal upheavals.

By factoring the future into the present, environmental, social and governance funds have shone despite pronounced market volatility in March 2020. They are no longer seen as purely a bull market luxury. Their resilience owes more to stock selection than sector bets.

They have also reminded pension investors that the success of ESG rests on a 'just transition' to a low-carbon future, unlike globalisation.

The latter created winners and losers in the West, in the absence of overt policies to help the victims of the resulting job losses and stagnant incomes. Like the rise of artificial intelligence, globalisation has delivered benefits, but these have come to many in their role as consumers, not as workers or citizens.

The 'S' factor – previously the overlooked middle child of ESG – has now come into its own. The zeitgeist is changing. Priorities that were already shifting may move even faster.

The implied green evangelism underscores our survey's core message: the old shareholder-primacy model can no longer be relied upon to create sustainable economies that will deliver affordable pensions to millions in an interconnected world where negative fat-tailed events are no longer a rarity.

This mindset shift marks a defining moment.

It could be one of the only positive legacies of this cataclysmic pandemic.

Theme 5 provides further details.

"Living through the pandemic is like experiencing the climate crisis with your finger stuck on the fast-forward button."

An interview quote

Theme 1 There is no single story to tell about Covid-19

Even before the virus outbreak, the global economy was trapped in a vicious cycle of low growth, low inflation, low interest rates and rising inequalities that together conspired to unleash a wave of populism. Escalating geopolitical risks, trade tensions, political polarisations, unchecked public sector deficits and an overlevered credit sector left the global economy too fragile to weather another shock. This dynamic has now been fast forwarded by mounting bankruptcies. A massive 'policy bazooka' was inevitable.

Led by the US Federal Reserve, major central banks and their governments have so far committed \$17 trillion to avert the large-scale economic devastation wreaked by the pandemic. Such was the unprecedented scale and speed of the response that it marked a revolution in macroeconomic policy. It upends all tenets of financial discipline.

First, the new policy measures bypass the financial system by channelling help directly to businesses and households, with central banks and governments working in tandem. Second, the resulting massive debt monetisation by central banks risks undermining their independence, weakening financial discipline among governments and igniting inflation further down the line. Third, government help for businesses comes with strings attached. These vastly expand the

scope of public intervention in both financial markets and corporate policies in areas such as dividends, share buybacks and business governance. On past form, mission creep seems inevitable.

What the end game will be and how the genie will be put back in the bottle is anyone's guess. Against that background, our survey respondents have identified the macro shifts that are likely to occur in the prevailing monetary order that could affect their asset allocation choices (Figure 1.1).

One area where the majority see a big shift is from freer markets to public intervention (56%). For the rest of the shifts in Figure 1.1, 'maybe' or 'very likely' are the dominant responses.

From the investor perspective, central banks' most unusual intervention in the securities markets marks a decisive break from the past. There was no alternative. Runs on these markets could disrupt credit flows, leading to unnecessary defaults and fire sales that could spark a 1929-style depression. On the flip side, it could mark a big shift.

History shows that inflection points in monetary regimes are hard to discern at the time. Markets always struggle to price in their inherent risks and rewards until well after they actually materialise. Hence, pension plans now prize portfolio resilience above all else.

History shows that inflection points in monetary regimes are hard to discern at the time. Markets always struggle to price in their inherent risks and rewards until they actually materialise.

Figure 1.1 How likely is it that the Covid-19 crisis will cause the following shifts in the global economy over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"An orderly exit from these unorthodox policies will be very hard without stoking up inflation."

"The days of hyper globalisation are over. Nations will turn inwards and create a poorer, smaller and meaner world."

Theme 2 Initial deflation might morph into stagflation over time

Because of the uncertainty around macro shifts, our survey respondents envisage a double doom loop buffeting the markets for the foreseeable future: a credit crisis, as financial systems struggle to cope with corporate bankruptcies; and an economic crisis as businesses are starved of credit. Months of social distancing could damage capital formation, employment and productivity growth. The risk of permanent supply-side damage to the global economy remains big and unquantifiable.

The risk of permanent supply-side damage to the global economy remains big and unquantifiable.

Hence, the majority of our survey respondents expect either a W-shaped recovery in markets or an accordion-shaped one (Figure 1.2). Both could be extraordinarily volatile by nature.

The first one envisages short recoveries hit intermittently by periodic relapses before entering a sustainable bull phase. The second envisages spurts of mini bull markets within an extended bear period. However, an effective vaccine in the near future on a mass scale could be a circuit breaker if it helps to limit permanent economic scars.

For the near term, a severe deflationary demand-side shock in the world economy is the most likely outcome and would tip it into recession. But if this ends up ravaging national economies' supply base and capital formation, it could potentially trigger a chain of events that could ignite an inflationary spiral. In the

key economies, inflation could well revert to levels not seen since the 1970s, if central banks fail to anchor inflation expectations. Thus, scenario planning by pension plans now factors in three likely outcomes: moral hazard, rising prices and volatility spikes.

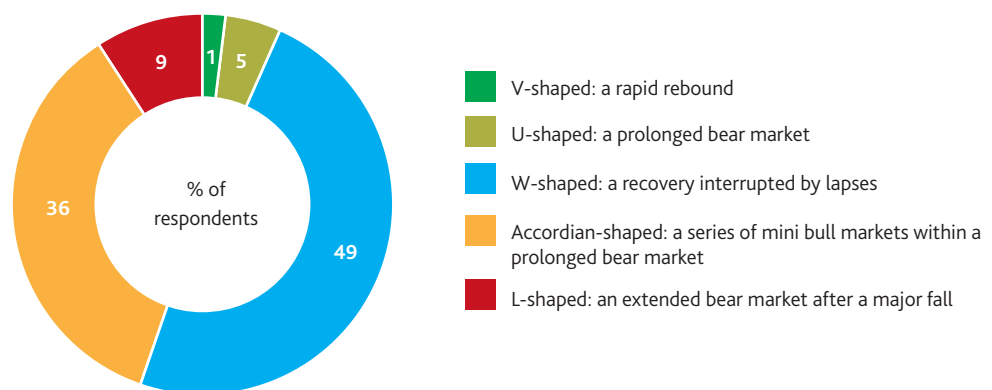
As recessionary clouds gather with the arrival of the second or third wave of Covid-19 in 2020, uppermost in the minds of pension plans is what to do if the 'whatever it takes' policy stance fails to avert a deep recession. If businesses are shutting down, super easy money policies can't achieve much.

Indeed, it is feared that, by committing to keeping rates zero bound, central banks might have opened a Pandora's box of uncontrolled fiscal expansion à la Modern Monetary Theory (aka the 'Magic Money Tree'). It is no longer an outlandish possibility. The shaking of the tree has only just begun, and it is likely to intensify under the Biden presidency, with its ambitious fiscal agenda.

This could potentially de-anchor inflation expectations around central banks' target level and revive the spectre of a 1970s-style stagflation: a lethal cocktail of economic stagnation and rising inflation. Policy fatigue and policy errors will remain major risks.

The tipping points are hard to predict. Hence, to pension investors, the future remains unusually shrouded in mystery.

Figure 1.2 How are financial markets likely to recover once the worst of the crisis is over?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"Collapses in monetary regimes come in periods of major upheaval."

"There is nothing so permanent as a temporary government programme. It's hard to put the genie back in the bottle."

Theme 3 Asset prices will most likely reconnect with their fair value

Since March 2020, it has been hard to justify rich pricing and buoyant stock markets in the face of the deep economic contraction seen in the West. Various reasons have been advanced; two key ones stand out.

First, the key market indices are being driven by a few technology firms that are benefiting from lockdown. Among the rest, many are nursing losses. Second, the Fed's aggressive action to stop a credit market crash has created the mother of all liquidity-induced rallies – disconnected from the dystopian reality of empty or semi-empty offices, hotels, factories, airports and train stations.

Under successive rounds of quantitative easing in the last decade, central banks had presided over the longest bull market in history by artificially setting a floor under asset prices and suppressing volatility. In an environment of anaemic economic growth, their actions only served to bring forward future returns.

Thus, 77% of our survey respondents believe that asset returns won't be as mouth-watering in this decade (Figure 1.3). They also believe that the more markets ignore business fundamentals and get addicted to central bank largesse, the harder it will be for them to allocate resources efficiently across economies. This would reinforce the inherent danger of stagflation and loss of confidence in central banks.

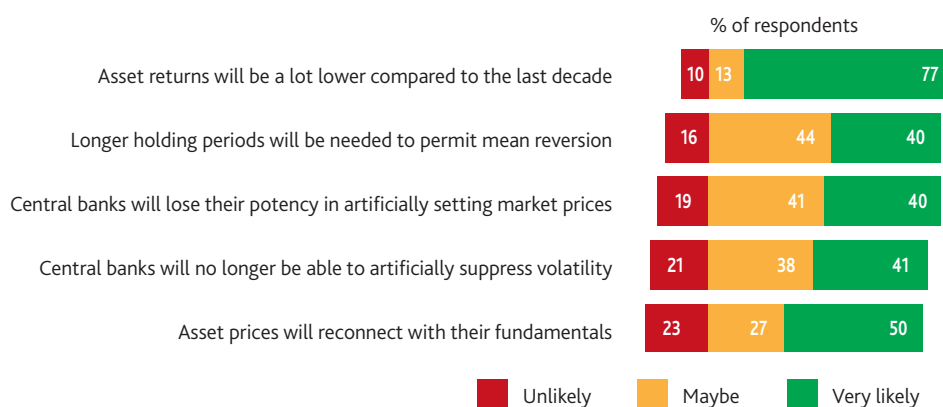
Hence, while welcoming the central bank action that staved off a 1929-style depression, our survey participants are all too aware that the latest revolution comes with its own price tag. The ultimate reckoning might wreck their portfolios. It is therefore prudent to plan for alternative scenarios.

50% of them believe that market prices will reconnect with their fundamentals (Figure 1.3). 40% accept that their asset holding periods will need to be longer to allow the resulting mean reversion to work. Around 40% believe that central banks will lose their potency in influencing asset prices and their volatility. This will either be from policy mis-steps or loss of independence or both, as their balance sheets explode. Sentiment will drive markets in the short-term before the fundamentals reassert themselves over this decade.

Our survey reveals a growing realisation that we may be nearing the end of the current monetary regime, which started with the arrival of Paul Volcker at the Fed in 1980 with a strong anti-inflation mandate. We may witness a structural break and return to inflation rates of 5% or more in this decade. After all, monetary policy works through financial markets. In so doing, it distorts financial activity, causes asset bubbles, worsens income and wealth inequalities and encourages inefficient firms to take on more debt. It cannot turn bad debt into good debt, or promote innovation.

We may be nearing the end of the current monetary regime that started in 1980 with the arrival of Paul Volcker at the Fed with a strong anti-inflation mandate.

Figure 1.3 Do you agree or disagree with the following statements on the overall impact of the identified macro shifts on asset valuations in this decade?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"In a crisis, fundamentals may seem irrelevant. But the reverse could be closer to the truth."

"The Fed has effectively nationalised the bond market. Will the US ever be able to return to free market capitalism as we know it?"

Theme 4 Portfolio resilience has raced up the pension agenda

With the global economy dogged by so much uncertainty, pension investors find themselves on a journey into the unknown. Relying on central banks to do all the heavy lifting to generate decent returns will no longer suffice. At the same time, it is not easy to adopt new investment approaches that have not been tested by time and events.

Portfolio robustness is now targeted by a much stronger reliance on two tools to prevent a permanent loss of capital: scenario planning and liquidity management.

They are left with three options. One is to ignore the likely shifts highlighted in the previous three themes – this in the belief that it is hard to know in advance whether they will actually materialise. Besides, markets have in-built automatic checks, balances and stabilisers. The second option is to adopt a pragmatic approach based on adaptive learning, as actual outcomes unfold over time. The third option is to adopt strong views about the likely future and make big calls in the hope that they work.

These options are duly reflected in our survey results. When asked whether the pandemic crisis will mark a turning point in how they do investing, 33% said 'very unlikely', 37% replied 'maybe' and 30% said 'very likely' (Figure 1.4, left chart).

The last two groups had one common objective: build resilient portfolios that cover

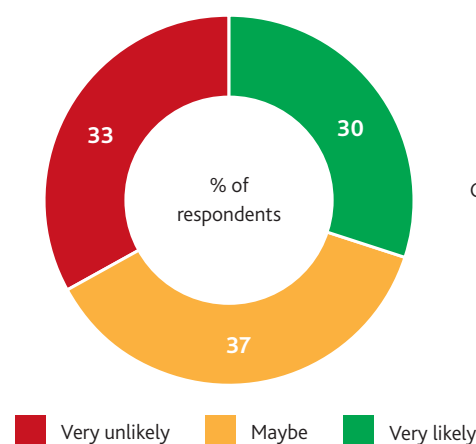
strategies with strong intrinsic worth that can withstand high volatility and deliver good risk-adjusted returns, while pursuing accelerating structural themes centred on the key growth points in the post-pandemic world (Figure 1.4, right chart, upper panel).

Resilience means investing on the side of change. It could be custom built, as is possible in private markets. It could be pursued via specific themes like ESG, healthcare and technology. It could be a strategy's inherent feature, as with cash flow compounders that act as shock absorbers in turbulent markets. Or it could have policy backstops, like the debt now being bought by the Fed.

In addition to risk factor diversification, portfolio robustness is now targeted by a much stronger reliance on two tools to prevent a permanent loss of capital: scenario planning and liquidity management (Figure 1.4, right chart, lower panel). The Covid-19 crisis has clearly shown how negative fat-tailed events can play havoc with portfolios.

The old probabilistic approach based on past pricing behaviour is no longer seen as enough. Back-to-basics characterises the new forward-looking approach in which investors feel the need to be prepared for the worst.

Figure 1.4 How likely is it that the Covid-19 crisis will mark a turning point in how investing is done?



Source: Amundi Asset Management/CREATE-Research Survey 2020

How is your plan targeting resilience in its portfolio?



Interview quotes

"There is no free lunch in diversification. You need clear beliefs rather than blind faith in ex ante numbers. Past trend is not destiny."

"The seeds of radical positive change are often sown in the depths of crises. The search for resilience could take investing back to its basics."

Theme 5 The pandemic has supercharged sustainable investing

When markets plunged in March 2020, some had predicted that investors' interest in environmental, social and governance investing will only prove to be a bull market luxury: financial returns will, perforce, race to the top of their agendas. So far, the naysayers have been proved wrong. If anything, the crisis has shown all too vividly how our economies can be so vulnerable to external forces at a speed previously unimagined.

As we shall see in Section 4, 52% of our survey respondents report that their ESG investments performed 'better than' the rest of the portfolio in the crisis, 45% said that they performed the 'same as' the rest and 3% reported 'worse than' the rest (page 35, Figure 4.2). Stock selection contributed more than the sector bets.

These numbers are all the more striking, since ESG funds are no longer peripheral to pension portfolios (Figure 1.5, left chart): 80% of respondents now have ESG funds accounting for more than 20% of their portfolio; half of them with a share of over 30%. Notably, 82% of the respondents also expect to increase their allocations over the medium term (Figure 1.5, right chart). The implied green evangelism is more than virtue signalling. It rests on the view that societies are moving away from the shareholder

primacy model. August 2019 marked a turning point when Business Roundtable, a powerful US corporate lobbying group, made a dramatic U-turn. It changed its old declaration from 'corporations exist to principally serve their shareholders' to 'we share a fundamental commitment to all our stakeholders – customers, employees, suppliers, communities and shareholders'. The old Friedmanite model of capitalism seems passé.

Just four months later, the European Union announced its legislative plans to deliver carbon neutrality by 2050. Before then, in the last decade, various governments had enacted over 500 new measures to promote environmental, social and governance issues.

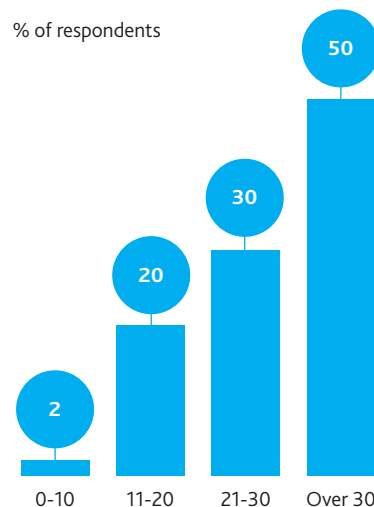
They aim to achieve a 'just transition' to a low-carbon future, unlike globalisation; which caused unpalatable side effects in the West: a hollowing out of middle-class jobs, stagnant real incomes and loss of essential skills. With multi-decade liabilities, pension plans want to ensure that their investments help create resilient economies that require resilient societies.

Priorities that were already shifting may change even faster.

With multi-decade liabilities, pension plans want to ensure that their investments help create resilient economies that require resilient societies.

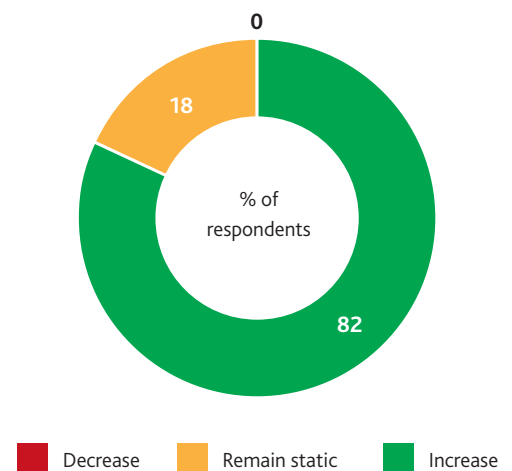
Figure 1.5

What is the approximate percentage of your pension plan's portfolio in ESG funds?



Source: Amundi Asset Management/CREATE-Research Survey 2020

How will this percentage change over the next 3-5 years as a result of the crisis?



Interview quotes

"Companies integrating the ESG approach in their business conduct have proved more resilient in this crisis."

"The seeds of radical change are often sown in a crisis. The pandemic has forced a big rethink on how we manage our money."

Theme 6 Equities will remain the engine of capital growth

Over the last decade, quantitative easing by central banks has been undermining the economics of workplace-based pensions – albeit as a side effect.

First, zero-bound interest rates have hugely inflated the present value of future liabilities and jacked-up funding deficits. Second, bond portfolios haven't yielded a decent enough income to fund regular payouts, forcing periodic raids on the capital base. Third, by artificially inflating asset prices, QE has brought forward future returns and ushered in an era of low prospective returns.

With the onset of the Covid-19 crisis, the unknowns are large in relation to what is priced in. Besides, previous rounds of quantitative easing have left markets with a weak immune system. Hence, three prime concerns will guide the asset choices of our survey respondents: ballooning funding deficits, maturing liabilities and inflation worries.

Accordingly, their future choices will target capital growth, income generation, inflation protection and asset conservation (Figure 1.6). Taking them in turn, equities will be at the vanguard of the drive to plug funding deficits. Also, on relative valuations, equities are likely to far outperform bonds. With their focus on

delivering resilient portfolios, the net result will be the bondification of certain equities: those with low debt and steady dividends backed by strong free cashflows, pricing power and brands.

For income generation, infrastructure, IG bonds and private debt are most likely to be favoured. Infrastructure will benefit from large-scale fiscal stimulus with special focus on renewable energy and its improving cost dynamics. In turn, the IG bonds space will benefit from being high on capital structure and enjoying central banks' protective umbrella in key economies.

In contrast, opportunities in private debt are likely to arise mostly from distressed situations caused by the weak covenants that came with its sky-rocketing growth in the last decade.

For inflation protection, the main reliance will be on equities, infrastructure and real estate covering high-performing segments prized as key sources of resilience: logistics, datacentres and social real estate.

Finally, for asset conservation, sovereign bonds will be favoured by a minority with good funding ratios that permit a high degree of portfolio de-risking. For the rest, these former safe havens could inflict financial repression.

With the onset of the Covid-19 crisis, the unknowns are large in relation to what is priced in.

Figure 1.6 Which asset classes will be favoured to meet your pension plan's goals over the next 3–5 years?

Most favoured asset classes		Least favoured asset classes	
	% of respondents		% of respondents
Global equities	76	Currency funds	1
Infrastructure	58	Communities (excluding gold)	4
High quality equities	53	Hedge funds	4
Private equity	46	Regional equities	4
IG corporation bonds in the USA	44	Japanese equities	8
IG corporation bonds in the EM	41	Gold	10
EM equities	40	Domestic equities	12
Private debt	38	Small cap equities	17
IG corporation bonds in Europe	36	EM government bonds	17
High yield bonds	35	US government bonds	18
Real estate (debt)	29	US equities	18
European government bonds	27		
Real estate (equity-based REITs)	23		
European equities	21		

Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"Value is not dead. It remains embedded in fundamentals not yet reflected in prices."

"With its in-built resilience, infrastructure will be the biggest winner of this crisis."

Theme 7 Covid-19 could be the last straw for many DB plans

By turning a raging bull market into a savage bear market, the pandemic has dealt a double blow to the finances of defined benefit plans.

Quite apart from inflating the present value of their future liabilities, falling rates also mean lower cash flows, as plans typically rely on bonds to fund regular payouts to their retirees. To cover the resulting shortfall, they have to invest even more or hold fire sales of their current assets. Thus, falling rates have proved to be the Achilles heel of DB plans. Worldwide, just over half of them have a hedge against falling rates.

Thus, the latest actions aim to: seek extra contributions from sponsors, make assets sweat harder and prune retirement benefits. On the latter front, serious attempts have been made over the last decade as rates continued to plummet under successive rounds of QE. They included raising the retirement age in line with life expectancy, upping employee contributions, withdrawing the automatic indexation of benefits and linking pension entitlement to an employee's career average, instead of final year salary. Being hardwired into employees' job contracts, these entitlements were difficult to downsize. But lump-sum one-off contributions from plan sponsors paved the

way for reforms. Since the crisis, the spotlight has turned on four areas (Figure 1.7).

48% of our respondents expect additional contributions from plan sponsors. Having already made a series of one-off cash injections before the crisis, their sponsor covenant risk is currently at an all-time high.

40% expect to extend the recovery period of their current deficit, so as to allow time to heal.

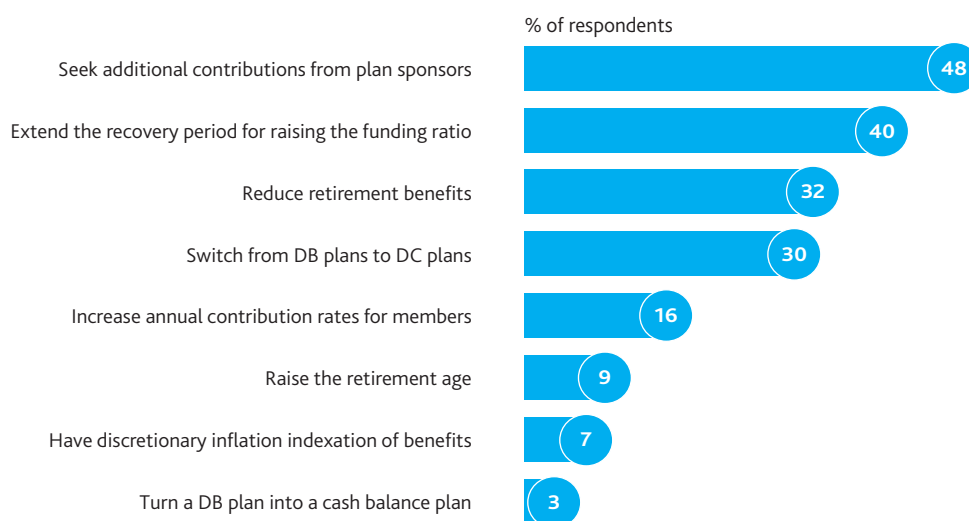
32% expect to reduce retirement benefits. Key items under discussion currently are the adoption of the career average salary formula and lump sum payments that shift inflation, interest rate and longevity risks to employees.

30% expect to switch from defined benefit to defined contribution plans where employees bear all the retirement risks. This trend accelerated in the last decade – even in rock-solid DB markets like Canada and Japan.

The harsh truth is that the DB pension promise was easy to make but hard to keep in an era of low rates. Unless pension laws are changed, plan sponsors can only chip away slowly at the benefits to contain their ballooning obligations.

Falling rates have proved the Achilles heel of DB plans. Worldwide, just over half of them have a hedge against falling rates.

Figure 1.7 What structural changes have your pension plan made (or does it intend to make) to ensure that it remains financially viable in the wake of the Covid-19 crisis?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

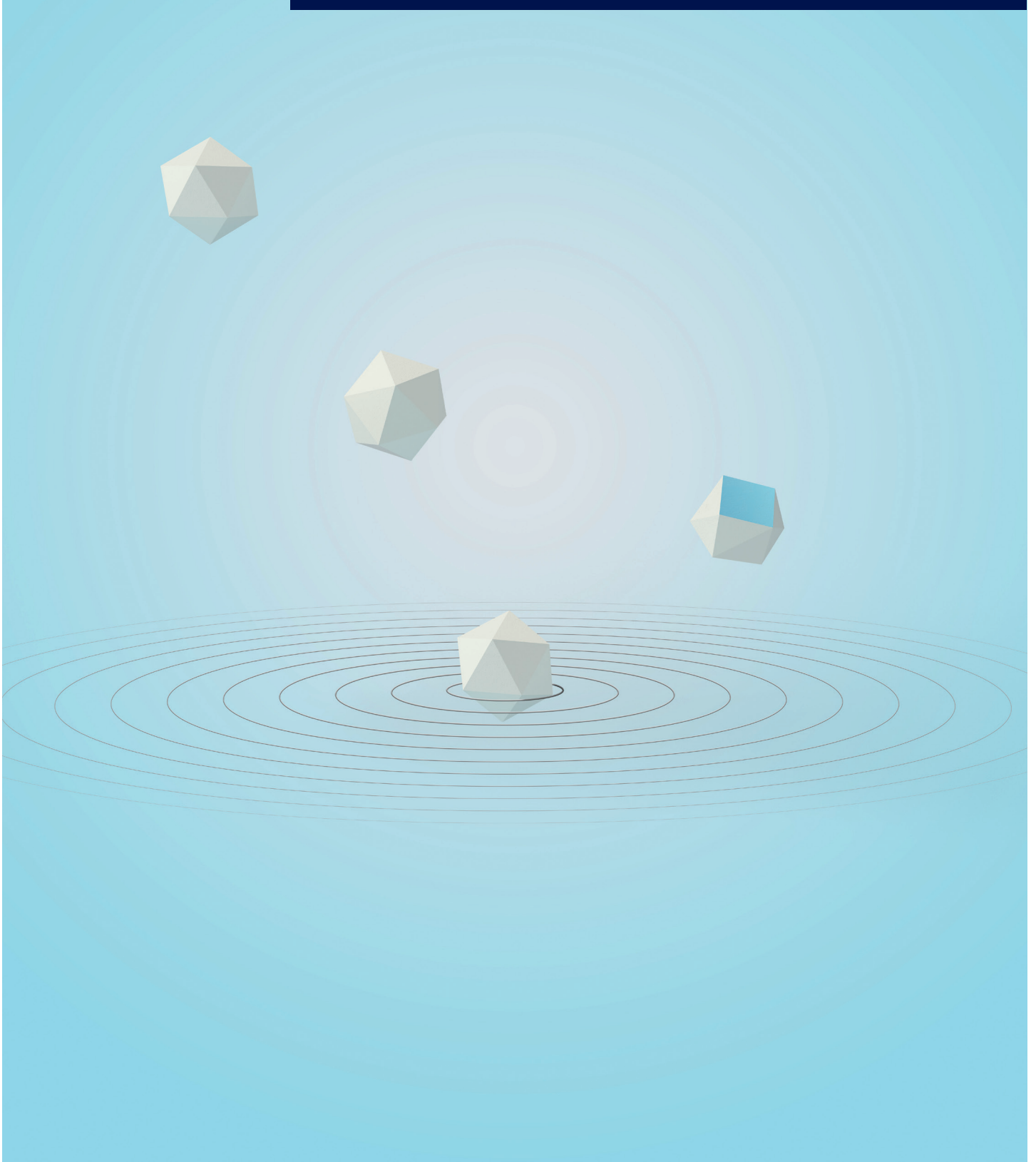
"By focusing on the macro economy, policy makers are willing to ignore the real problems that are metastasizing in the pension world."

"I don't think anybody knows how many DB plans will survive this crisis, unless there is a 20-year raging equity bull market."

2

Asset allocation in the age of uncertainty

What will be new and what will be different?



Overview

Taking a 3–5 year forward look, this section highlights the changes in pension plans' approaches in the face of radical uncertainty:

- investment beliefs
- asset allocation tools
- investment strategies
- investment vehicles.

Key findings

Portfolio resilience will be the hallmark of investing, as pension plans look beyond the immediate pandemic and seek to future-proof their portfolios for a prolonged era of ambiguity created by the unique exhaustive power of the pandemic. The longer it lasts, the greater the risk of permanent damage to the global economy's productive base.

Hence, apart from risk and return, asset allocation will have two additional pillars: liquidity and resilience. Both will transcend all four areas of asset allocation shown below.

a. Investment beliefs

Investing will centre on firms that can weather the storm and emerge stronger.

As recessionary clouds gather with the arrival of the second and third waves of Covid-19, uppermost in the minds of pension plans is what to do if the 'whatever it takes' policy stance of key governments fails to avert a deep recession.

The resulting erosion of central bank credibility risks seeing the return of inflation. As a result:

- with increased volatility, investing will become a long-term game
- asset values will tend to revert to their mean regularly and reconnect with their fundamentals
- value investing will experience a revival.

b. Asset allocation tools

Asset allocation will target four goals: capital growth to clear pension deficits, income to generate regular cash flows, asset conservation to remain solvent and hedges to manage unrewarded risks.

These will be pursued by:

- diversifying portfolios by risk factors
- having a more pronounced separation of alpha and beta
- putting ESG investing at the vanguard of the drive towards portfolio resiliency
- treating liquidity as a third pillar of investing.

c. Investment strategies

Policy stimulus is likely to accelerate established trends towards thematic investing that aims to pursue resilience.

Favoured strategies will include:

- private market assets with custom-built resilience
- investment themes that offer inherent resilience
- selective assets that enjoy policy backstops
- cash flow compounders that minimise drawdown in periods of market dislocation.

d. Investment vehicles

The alpha–beta separation will become more structurally pronounced, as fees become a key source of outperformance in a prospective low-return environment.

Passive funds will increasingly advance into core portfolios.

In the process, the favoured vehicles will include:

- theme-based index funds
- exchange traded funds
- multi-asset funds.

"Central banks are pushing on a string trying in vain to whip up economic recovery with monetary policy."

An interview quote

Investing will focus on firms that can weather the storm

The monetary policy stance on either side of the Atlantic is now at its loosest: after allowing for QE, the rates are -10% in the US and -6% in the UK.

Hence, pension plans' current concerns include: what if policymakers' 'whatever it takes' approach does not stave off a deep recession? And even if it does, will governments get so used to running ever-larger deficits, backstopped by central banks, that they become reluctant to forego that privilege? As a result, will inflation and financial repression become key policy weapons?

After all, public spending could become less coordinated and even more susceptible to influence by pressure groups and policy mis-steps in the face of mission creep. Things could get much more sluggish than otherwise expected.

Indeed, over the past two decades, businesses have become ever more dependent on policy makers for easy credit and generous bailouts to the detriment of entrepreneurial risk and more efficient allocation of capital.

These practices have fuelled two trends: the rise of mega firms, who are quick to acquire their new innovative competitors and become oligopolies; and 'zombie' firms – unable to cover their debt costs – which have been kept alive at the expense of start-ups.

The result has been low productivity and anaemic growth, giving rise to social tensions. This process has now received fresh impetus, as policymakers rush to avoid large-scale bankruptcies in this crisis (see [Insights](#) on the next page).

On the upside, however, some progressive governments might even address long-standing social ills by large-scale enlightened public programmes, like the 'New Deal' in the US in the 1930s. Either way, the role of governments is set to mushroom.

Within this broad context, our survey aimed to unearth the core beliefs that will underpin investing over the next 3–5 years (Figure 2.1). Three clusters are evident. Together, they mark a strong shift to the basics of investing but with a pronounced tilt towards resilience.

Businesses have become ever more dependent on policy makers for easy credit and generous bailouts to the detriment of entrepreneurial risk and the more efficient allocation of capital.

Figure 2.1 In light of the Covid-19 crisis, which of these statements describes your pension plan's investment beliefs over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"The days of outsized share buy-backs and dividends, which artificially inflated share prices, are over for the foreseeable future."

"This crisis will not last for decades, but some of its effects will. Being nimble and forward thinking will be vital for survival."

The time-varying nature of correlations requires greater granularity in the way assets are allocated.

The first cluster reaffirms the old truism that in an era of heightened uncertainty and volatility, investing has to be long haul, as highlighted by 76% of our respondents.

This is underpinned by three other beliefs: buy-and-hold investing will deliver better returns (52%), since asset values will tend to revert to the mean more regularly as markets become overly distorted by unusual policy action (51%). Such reversion will re-connect valuations to their fair value (49%). Thus, value investing may well revive after lying dormant for two decades (42%).

The second cluster focuses on ESG, which is expected to become a structural feature of long-term investing that targets a double bottom line: doing good and doing well (63%).

As we shall see later, ESG will cut across a number of newly emerging themes that target the selective bright spots in the global economy, as it shifts from shareholder capitalism to a more inclusive stakeholder model. Covid-19 has shown all too vividly that resilient economies need resilient societies.

ESG investing is expected to be at the vanguard of the renewed drive towards resiliency.

The third and final cluster cautions against the limitations of old-style diversification based on asset classes. Only a minority believes that it will deliver a free lunch (36%). Indeed, it failed miserably when it was needed most amid the market rout in March 2020 as well as in the 2008 financial crisis. Correlations between supposedly uncorrelated asset classes have proved asymmetric: low in the rising market and high in the falling market. This time-varying nature of correlations requires greater granularity in the way assets are allocated. It also requires a certain degree of opportunism in periods of extreme market dislocation. Only 11% believe that a 'buy the dips' mentality will not be rewarding.

Thus, the Covid-19 crisis has reduced investing to a single imperative: anti-fragility. That means creating portfolios that can withstand pronounced periodic shocks in the near term, while targeting growth and income upsides thereafter.

Interview quotes *"Anyone can see the dangers of solving the debt problem with yet more debt. Like a python, debt is constricting global growth."*

"Rising inflation is far more likely than markets currently think. It will be a key part of the solution to the huge global debt problem."

Insights

Current policy revolution risks eroding central bank credibility

The longer the current unorthodox policy intervention lasts, the greater the distortions in the real economy as well as in financial markets.

For now, the world remains in a deflationary dive from negative demand shock. But if the stimulus fails to reboot the global economy in the presence of a big negative supply shock, inflation will emerge much earlier in the next cycle.

Two factors might tie central banks' hands in anchoring inflation expectations: high debt levels and implicit yield curve control, as central banks cap borrowing costs across the curve to assist debt monetisation. In the past, this has de facto passed the

control of inflation from central banks to governments. Inflation expectations can become unanchored and emerge as a separate driver of inflation in its own right.

We may well see a structural break in the current inflation regime with the partial unwinding of free trade and reduced business competition due to bankruptcies. No wonder the Fed has now adopted 'average inflation targeting'. Besides, the only way to shrink the global debt mountain is to inflate it away.

Thus, the Fed's credibility is now on the line. Its unusual decision to buy sub-investment grade debt at the height of the crisis was driven by the

understandable desire to avoid the threats of unnecessary defaults and fire sales in the real economy. But it is hard to believe that it will not affect the workings of the securities markets in future.

Many investors are now buying what the Fed buys. The process of competitive capital allocation to worthy companies is severely impaired. This is surreal.

~ A US pension plan

Asset allocation will pursue multiple goals

As Theme 3 in the *Executive Summary* showed, our survey respondents now expect a low-return environment with pronounced volatility, since recoveries in national economies will follow variable time paths due to subsequent waves of the virus globally at the end of 2020. In the near term, only temporary relief is expected, not full and stable recovery.

Hence, asset allocation will be recast in two respects: goals and selectivity.

These multiple objectives are likely to be pursued through a marked selectivity in asset choices.

To start with, pension plans are targeting the following: capital growth to clear deficits; income to generate cash flows for regular payouts; inflation protection to preserve the real value of assets, asset conservation to remain solvent; and hedges to manage unrewarded risks like interest rates, inflation and longevity. Apart from correlating with liabilities, hedges also target credit spread, duration and liquidity.

47% of our respondents will be adopting these multiple objectives within their existing LDI programmes, as shown in Figure 2.2. Many others also expect to have a distinct slant towards them, given that high returns are

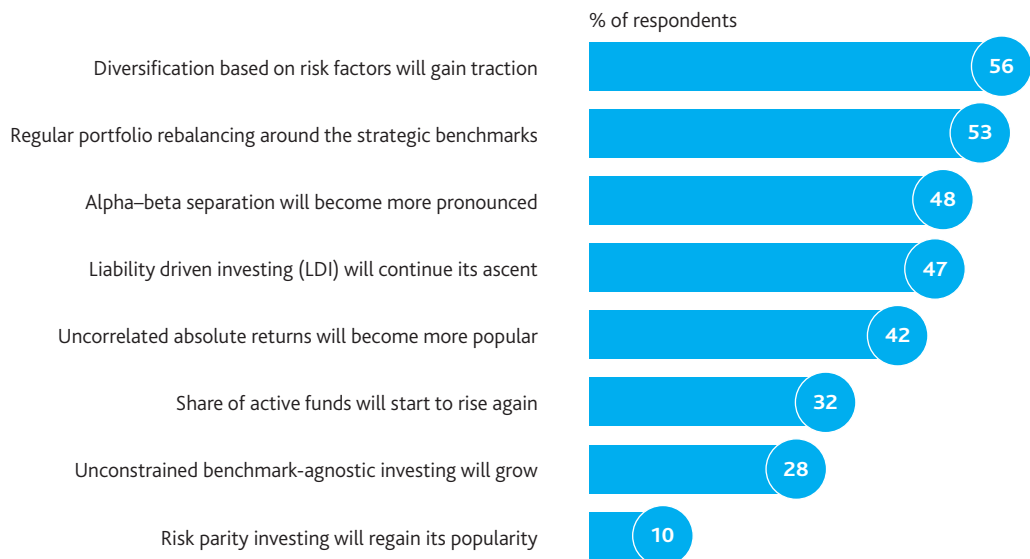
unlikely in the challenging environment ahead. In all cases, however, the emphasis on cash-flow assets is dictated by the fact that DB plans are now advancing into their run-off phase with ageing demographics, pushing 64% of European plans into negative cash flow status in 2019. The trend will accelerate as many DB plans continue to close future accruals, raising net cash outflows up as a side effect.

In turn, these multiple objectives are likely to be pursued through marked selectivity in asset choices. First, 56% of respondents expect to diversify their risk by allocating assets by risk factors, instead of asset classes: this in the belief that periodic dislocation will increase the correlation between historically lowly correlated asset classes. In the process, they will focus on macro factors like GDP growth, inflation, volatility and interest rates, as well as micro factors such as size, value, quality, variance, currency, capital structure and default rates.

The aim is to do a granular analysis of the behaviours of all asset classes under different future macroeconomic scenarios before choosing the right ones. In the risk models, the emphasis will shift from the past to the future.

Figure 2.2

Which of these statements describes your pension plan's views on various asset allocation tools over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"Markets have not been paying attention to the worst stealth tax – inflation. They should."

"In March, the correlation between equities, bonds and gold went up, nullifying the benefits of diversification."

The trade-off between liquidity and return is as valid as that between risk and return.

Such selectivity will be reinforced via regular portfolio rebalancing as and when fresh market entry points emerge after periodic dislocations that open up big discounts to intrinsic value (53%).

Selectivity will accelerate the long-standing separation between alpha and beta (48%). Alpha strategies will focus on inefficient illiquid markets whereas beta ones will be used in deep liquid markets, especially in the West.

The search for uncorrelated returns will intensify so as to minimise the mark-to-market risk in periods of severe market dislocation (42%). It will serve to create tailwinds behind active management, since portfolio rebalancing is likely to occur more often than not.

Finally, the twin emphasis on multiplicity of objectives and selectivity of asset choices is underpinned by one overriding consideration: liquidity.

Its dramatic evaporation from global financial markets at the start of the Covid-19 crisis in March 2020 served as a stark reminder – if one were needed – of the centrality of

liquidity to the investment process. The trade-off between liquidity and return is as valid as that between risk and return. Indeed, liquidity episodes in the last decade hold two lessons (see [Insights](#)).

First, liquidity injections by central banks, via low interest rates and bond purchases, invariably forced investors up the risk curve, creating countless convictionless trades under the illusion that liquidity will always be there while the global economy was awash with cash. Yet, the experience of the last three bear markets shows otherwise. Panic buying and selling have been all too clear.

Second, such episodes have been exacerbated in fixed income markets, due to the withdrawal of investment banks from their market-making role under new regulations after the 2008 crisis. Banks now bear fewer risks by simply shifting them elsewhere in the system, notably onto investors. This shift is likened to pressing on a waterbed in one place causing the displaced water to move elsewhere in the mattress. Investors are wising up to this.

Interview quotes *"Like diversification, liquidity vanishes when it is most needed. It provides oxygen to markets."*

"If businesses are shutting down, super easy money policies can't achieve much."

Insights

Liquidity will emerge as the third pillar of investing

Following the immediate relief from the extreme market seizure in March 2020, it is too soon to expect a full and stable economic recovery while most nations are still in the throes of a second wave of the virus.

It is one thing for central banks to adopt a 'whatever it takes' response but quite another to make it work due to a clear distinction between liquidity and solvency in the real economy.

Liquidity refers to a firm's ability to honour its short-term liabilities with its current assets. Solvency relates to its ability to honour its long-term financial obligations in order to survive as a going concern.

Central banks have provided immediate liquidity to the real economy. Arguably, it is more suited to a conventional credit crisis rather than the current one where people fear for their health and are afraid to go out to work or the shops.

The risk of a solvency crisis is high if firms' revenues continue to fall precipitously, especially in levered economies where corporate debt has been rising steeply in the last decade, assisted by cheap credit. In the US, BBB-rated debt, just one notch above high yield, now covers nearly half the IG bond universe.

The numbers of debt restructurings, debt forbearances and ultimately

bankruptcies are likely to rise exponentially the longer the lockdown lasts.

In this scenario, financial markets cannot remain immune. We have duly altered our asset allocation criteria: liquidity is now the third pillar on a par with risk and return. Liquidity filters are firmly embedded in all the stress tests we do.

~ An Australian pension plan

Focus on resilience will be turbocharging theme investing

In previous crises, policy action targeted bricks and mortar projects. In the current one, it targets green and digital sectors in the key economies. The European Union's Green New Deal worth €225 billion is a case in point.

Sectors that have been singled out include: life sciences, electric vehicles, renewable energy, green real estate, waste management, biotechnologies, advanced materials, smart cities, robotics, and the 5G and Wi Fi 6 digital networks powered by big data. Most of these are interrelated. Advances in artificial intelligence are fostering new industries from gene therapy to space travel. Crisis is accelerating change.

Mega trends have been powering these and other sectors this century. They matter to investors because they disrupt industries. They also give rise to clear and predictable sources of value creation. They have a multi-year return profile and favour intangible assets that make them relatively immune to the normal business cycles, as revealed by FAANG stocks, with digital consumption going through the roof lately (see [Insights](#) on next page).

There is another reason why theme investing is set for take-off: the Fed's decision to keep rates 'even lower for longer'. They not only amount to an arbitrary redistribution of wealth from savers to borrowers; they will also accentuate distortions in asset values as well as widen income inequalities.

The list of zombie companies, kept afloat by low rates despite overborrowing, will continue to grow. There will be a continuing shift in the capital structure of companies away from equity to debt, while overvalued bonds will take longer to return to their intrinsic value. Green bonds apart, they are no longer perceived as a safe haven. Above all, central bank action risks a serious overreach that could roil markets from time to time. It seems unwise to rely on it to do all the heavy lifting when targeting good returns.

Against this backdrop, our survey respondents have identified strategies that are likely to influence their investment approach (Figure 2.3). Their central thrust is directed at investing in structurally advantaged companies, sectors, regions and markets that

Mega trends disrupt industries. They also give rise to clear and predictable sources of value creation.

Figure 2.3 Which of these statements describes your pension plan's views on various investment strategies over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"The direction of our asset choices is influenced more by mega trends than business sectors."

"Our ownership mentality works best in private markets with a multi-year return profile."

Private markets are perceived to be more long-term in their approach to value creation.

enhance portfolio resilience, while targeting capital growth and income. Taking them in turn, for capital growth, three interrelated strategies are likely to be targeted.

75% of our respondents single out private markets. Apart from their traditional illiquidity premium, they are likely to shelter growth companies in growth industries running with the grain of the growth theme. Public companies are deemed too short-termist with their over-emphasis on quarterly numbers. By comparison, private markets are perceived to be more long term in their approach to value creation. For large investors, they also offer the opportunity to wield more influence via secure covenants that promise custom-made resilience in pursuit of various themes.

Another growth strategy centres on themes (58%). ESG and digital will be among the most prominent, especially the former. Societies are expected to inch towards a more inclusive model of capitalism, as investors and consumers become more vocal about businesses perceived as failing to take their societal role seriously. In hindsight, Covid-19 is likely to be a watershed moment for ESG investing as we shall see in Section 4.

The final growth strategy relates to emerging markets (43%) on account of the favourable growth dynamics of the key Asian markets after successfully tackling the virus by the end of 2020.

Turning to income, two strategies are likely to be targeted. One is cash flow compounders, covering companies with steady dividends, strong balance sheets, free cash flow, a strong brand and good pricing power (53%). Another is alternative assets like infrastructure and real estate that deliver regular cash flow and inflation protection (39%).

Overall, two imperatives underscore this pronounced emphasis on resilience: the structural trends accelerated by the pandemic and the selectivity they require in asset choices. Hence bottom-up stock selection could make a big come-back (46%).

Overall, resilience is now the fourth pillar of asset allocation, alongside risk, return and liquidity.

Interview quotes *"Net capital raising is negative in US equity markets, as growing businesses prefer to finance their capital projects privately."*

"Businesses will be investing increasingly large amounts in intangibles – IP, data and software – to try and do more with less."

Insights

Theme funds will be the next 'hot spots' especially in private markets

The most important investment question we ask before buying anything at the moment is whether a company is resilient enough to survive a deep recession. The answer invariably takes us to theme funds that transcend typical market boundaries and categorisation by the conventional country, sector or style factors. Such funds often provide structural tailwinds for sustainable growth and profitability.

Currently, we are already invested in three generic themes. The first one is demographics: focusing on health care, urbanisation and the growth dynamics of EM. The second is technology: centred on artificial intelligence, 5G networks and cloud

computing. The third is ESG: focusing on renewable energy, labour practices and corporate governance.

Some of these themes also favour business models that largely rely on intangible assets, allowing them to scale very rapidly without much physical capital. Their owners prefer to deal with fewer but larger investors, so as to retain ownership. They prefer to remain in private markets where the discipline of quarterly earnings is suppressed by the goal of long-term value creation. They also enable us to side-step the mark-to-market financial disciplines that come with owning publicly quoted companies exposed to big volatility swings.

Over the past fifty years, stock prices have grown considerably. But it has been mostly driven by new companies, not established market leaders. The latest generation of the US and Chinese tech titans provide the best examples.

~ A UK pension plan

Index investing will tilt towards themes as it grows

As we saw in Figure 2.2, 48% of our survey respondents see alpha–beta separation as structural and likely to get more pronounced in the low-return environment of this decade, where fees will be a key source of outperformance when compounded over time. But there are other reasons as well.

To start with, alpha–beta separation marks the next stage in the evolution of the core–satellite model. It distinguishes between liquid efficient markets and illiquid inefficient markets. Markets have become more efficient as the number of talented asset managers has grown faster than return opportunities. Thus, whatever its size, alpha has to be shared between too many players. And investors have grown weary of paying alpha fees for beta performance.

Another key reason is the liquidity pumped in by central banks whenever markets hit a turbulent phase. The QE programmes of the last decade marked yet another milestone in a long process that has, over time, turned returns into a monetary phenomenon, influenced more by central bank largesse than by the earnings boost in the real economy. By effectively providing a floor under asset prices and suppressing volatility, central bank action has distorted asset prices, undermining active

investing in favour of plain vanilla passive funds (see [Insights](#) on the next page).

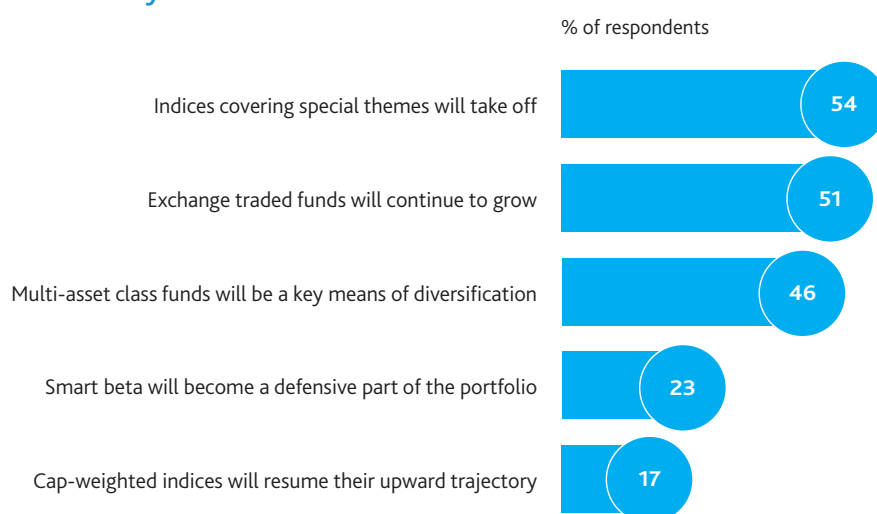
With the latest round of stimuli since the pandemic peak in March 2020, this trend is unlikely to abate anytime soon, except for one difference: the market rebound is more likely to favour theme funds, according to 54% of respondents (Figure 2.4). The reason is simple: investment styles are only as durable as the forces that promote them. Passives are not an all-weather strategy. Their focus on themes is meant to reduce big drawdowns in periods of market dislocation, while targeting durable bright spots in the global economy.

This is corroborated by the most narrow and unbalanced rally on record, which started after the market rout in March 2020. The market cap-weighted version of the S&P 500 has far outperformed the equal-weighted version: implying that the average stock did far worse than the overall index. Evidently, the gains were exclusively notched up by a few big tech giants in the US as well as in Asia. That trend has eased somewhat lately.

But the fact remains: passives are viewed as a cost-effective vehicle for pursuing the newly emerging structural themes in this decade, as described in the previous subsection.

Passives are not an all-weather strategy. Their focus on themes is meant to reduce big drawdowns in periods of market dislocation, while targeting durable bright spots in the global economy

Figure 2.4 Which of these statements describes your pension plan's views about investment vehicles over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"Passives and actives complement one another in the new core–satellite model. We index the core and manage the hell out of the periphery."

"The perception that the Fed would always intervene whenever markets dive is now deeply ingrained in the investor psyche."

ETFs will be at the vanguard of the march towards theme investing.

No wonder the low-cost train is likely to pick up speed.

This observation especially applies to small and medium-sized pension plans with limited expertise and governance budgets. Hitherto, most of them have relied on passive funds for their global diversification.

Thus, traditional cap-weighted funds are likely to have slower growth, as cited by 17% of respondents. Their popularity rose over the past two years when markets were experiencing strong upward momentum; especially since 2019, when the Fed reversed its rate hiking programme after the major market rout at the end of 2018.

In contrast, ETFs are likely to be favoured by 51%, since they are viewed as the perfect vehicle for executing risk-on/risk-off trades as and when the existing volatility regime changes. They are also favoured as a cash equitization tool for parking excess cash that would otherwise languish in a near-zero interest rate bank account. Above all, ETFs will be at the vanguard of the march towards theme investing.

Finally, multi-asset funds will be favoured, especially by small- and medium-sized pension plans (46%) owing to their three perceived positives.

First, their fees are charged on the net performance of all the strategies covered by each vehicle; unlike single strategy funds where fees are charged separately for each strategy, thus creating so-called 'netting risk'.

Second, multi-asset investing promotes a deeper understanding of changing correlations between various asset classes. This enables portfolio managers to identify problematic exposures and take timely pre-emptive action.

Finally, multi-asset investing offers managers greater latitude to hold more concentrated positions in their 'best ideas' portfolios that can potentially deliver the most attractive risk-adjusted returns via long-short strategies.

On the flip side, one charge frequently levied against multi-asset investing is that the sheer breadth of its universe often results in excessive beta exposure that can be readily replicated by long or short positions in ETFs.

Interview quotes *"ETFs are an easy route into an asset class without having to pick individual funds."*

"Multi-asset funds help deliver intelligent diversification that reduces correlation."

Insights

Passive funds are moving towards the centre of the core-satellite model

Over the past 20 years, passives have experienced a secular rise, due to two main factors.

First, there are too many managers fishing in a limited pool of market-beating opportunities. Markets are becoming more efficient. Everyone has to run faster just to stand still.

The second factor is the \$16 trillion of liquidity pumped into markets by central banks in the last decade after the 2008 crisis, artificially boosting asset prices. It made passives a one-way bet.

Together, these two factors have recalibrated the traditional core-satellite model and pushed passive funds into the

core area, dominated by assets trading in deep liquid markets. The satellites are thus left with assets that trade in less liquid volatile markets prone to alpha generation via active funds.

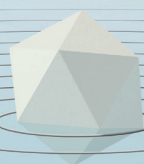
We worry about pronounced concentration in the indices, as displayed by the S&P 500 hitting a bear market low of 2237 in March 2020. By the end of August, it had recovered dramatically, posting an 8% year-to-date total return. Of this, five FAANG stocks contributed 12%, leaving the remaining 495 companies to post negative returns. The big five grew their earnings in the second quarter during the severe economic contraction while the rest were nursing losses.

Notably, FAANG stocks are all in the early stage of their lifecycles, with little or no regulatory burden. The incoming Biden administration in the US or a massive cyber-attack could change all that. But the key remains: like actives, passives will also benefit from the rise of theme investing.

~ A Finnish pension plan

3 Rise of goals-oriented investing

Which asset classes will be favoured?



Overview

Taking a 3–5 year forward view, this section highlights:

- the asset classes most likely to be favoured
- the risk tools that will underpin their choices
- improving investor perceptions about long-term investing.

Key findings

a. Asset classes

Asset allocation will target four goals. Along with the supporting asset classes that will underpin them, they are:

- *capital growth*: global equities, EM equities, high-quality equities
- *income generation*: infrastructure, IG bonds and private debt
- *inflation protection*: equities and infrastructure
- *asset conservation*: sovereign bonds.

Equities are expected to be the engine of capital growth in this low prospective return era; especially the so-called cash flow compounders. Selective EM debt will be another bright spot.

Sovereign bonds are unlikely to provide as much ballast as they have done in the past owing to their ultra-low total returns and inflationary exposures.

b. Risk tools

Since sovereign bonds are expected to make minimal total returns, risk tools will rely overly on other means:

- scenario planning
- liquidity management
- greater asset class diversification
- greater reliance on risk factors in asset allocation.

As extreme events with outsized market effects are becoming more common, portfolios will seek greater agility via renewed emphasis on scenario planning and better liquidity buffers.

c. Perceptions on long-term investing

Extreme fragility is exposing the fault lines in the ecosystems of equity markets that have built up over the years, as equities have become ever more disconnected from their fundamentals, influenced as they are more by central bank action than by the real economy.

Known risks are overpowered by unknowable uncertainties.

This is manifested by:

- active investing turning into second order trading of existing paper assets instead of value creation
- phenomenal growth in the ranks of zombie companies that don't make enough to pay the interest charges on their debt
- a steep rise in share buy-backs via balance sheet leverage to artificially boost earnings per share.

In the pursuit of resilience, there has been increased interest in long-term investing that is divorced from short-term financial engineering.

Market fragility is creating tailwinds for long-term investing.

"Investing is an endless game of 'whack-a-mole'. As one risk is removed, another one appears."

An interview quote

Equities will remain a bright spot on relative valuation

Many pathways now exist for the global economy. Some could lead to a deep recession, especially if the impact of the virus continues to weigh on aggregate demand well into 2021 and expose vulnerabilities in heavily levered firms.

Yet, other pathways show that the recession we are facing could be very unusual. Firms with a digital footprint will survive and thrive. Those with a physical footprint will be hit hard, giving rise to supply bottlenecks over time. More policy stimulus may be needed to offset the demand loss and support vulnerable sectors.

Hence, on a 3–5 year view, it would be hard to find anything that is mouth-watering. As a result, pension plans' asset choices will target four benefits against the background of mounting pension deficits, maturing liabilities, inflationary fears and market uncertainty. Respectively, the benefits are: capital growth, income generation, inflation protection and asset conservation (Figure 3.1).

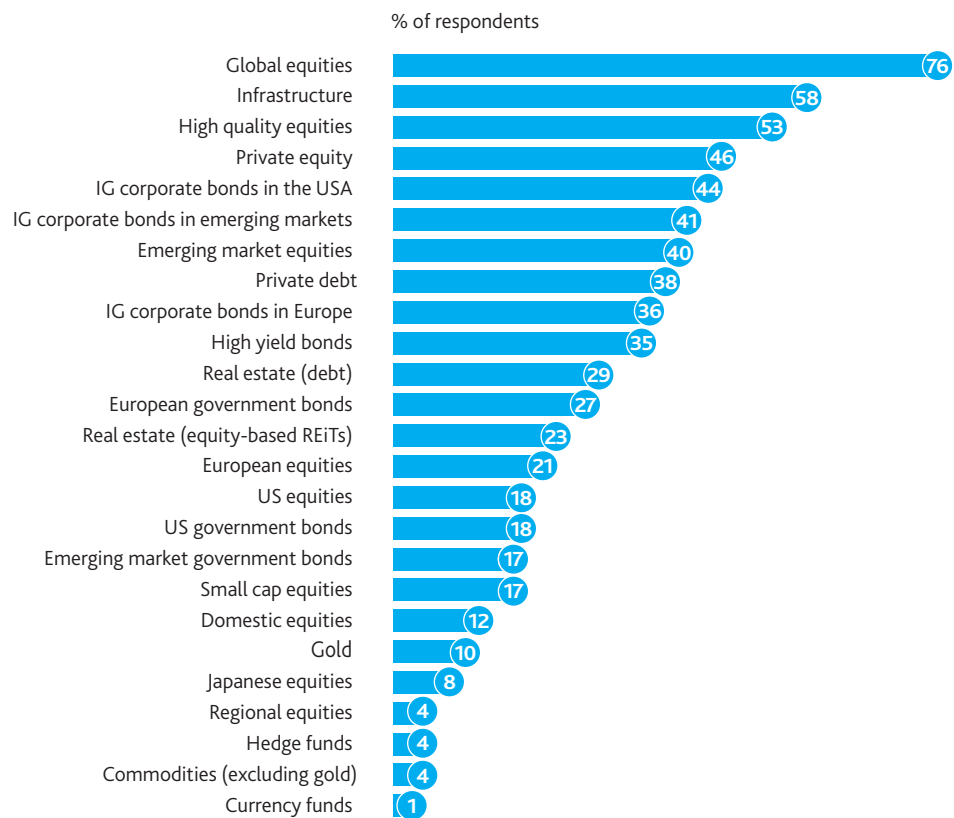
Taking them in turn, equities will be singled out as the engine of capital growth in this low prospective return era. Three types will attract special interest: global equities (cited by 76%), high-quality equities (53%) and emerging market equities (40%). Negative real yield on bonds and inflation worries will be added factors.

The interest in equities is also part of a delicate balancing act. On one side, recognising that future returns for most asset classes will be a lot lower than in the recent past. And, on the other side, avoiding the regret of missing out on the latest risk-on trade buoyed by central bank largesse. The net result will be the 'bondification' of selective equities: ones with good dividends, less debt, strong pricing power, strong brand and free cash flow.

Private equity is also likely to attract interest (46%) – albeit less than in our previous surveys.

Equities will be singled out as the engine of capital growth in this low prospective return era.

Figure 3.1 Which asset classes will be most suited to meeting your plan's goals over the next 3–5 years?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"The policy stimulus is unlikely to be the prelude of a decade-long equity bull market, as happened after the 2008 crisis."

"Equities and infrastructure will serve to provide inflation protection on top of decent total returns."

Renewable energy will be the sector with the most investor interest.

Its return dispersions are now widening: the gap between the best and the rest is already huge.

As for income generation, five asset classes will be favoured: infrastructure (58%), IG bonds in the US (44%); IG bonds in EM (41%), private debt (38%) and IG bonds in Europe (36%); see [Insights](#) below. Infrastructure will benefit from large-scale fiscal stimulus. Renewable energy will be the sector with the most investor interest. In turn, the IG space will benefit from two advantages: being high up on capital structure and enjoying central banks' protective umbrella. As for private debt – hitherto a preferred alternative to bonds – the story is different. It has increased fourfold since 2007 to \$813 billion in 2019, with an estimated \$297 billion in 'dry powder' at the start of 2020. But even before the crisis, rapid growth had raised serious concerns – weak covenants, excessive leverage and concentrated portfolios. Hence, investor interest will be in distressed debt or special situations, not new issuance. Besides, the unusual central bank support will help financially strained firms to rely on public markets.

As for inflation protection, equities and infrastructure will be favoured; commodities and real estate much less so. The latter will likely serve as another building block of the

post-pandemic world where home is the new office and video conferencing is the new meeting room. This calls into question the future of office space in inner city areas. Hence, interest in real estate (debt) is likely to be lower (29%). It will favour the high-performing nuggets of resilience: social real estate, logistics and datacentres.

Moving on to the fourth goal of our respondents – asset conservation – sovereign bonds will be favoured by a minority with good funding ratios that permit full portfolio de-risking. Notably, only 18% will favour US treasuries. Their near-zero yield is a major deterrent from a total return perspective in this era of 'low for even longer' rates. Their investors are likely to suffer the sort of financial repression seen in the US in the 1940s when rates were kept low to fund the post-war recovery. Key asset conservation efforts will focus on the risk tools described in the next subsection.

Finally, gold's rising popularity in 2020 owes to it being a hedge against central banks' policy of never-ending money printing. But, as an asset class, it is not big enough to offer protection for the trillions in pension portfolios.

Interview quotes *"Signs of a revival in animal spirits are there, but we also keep an eye on bankruptcies."*

"For investors, the sun will rise favourably in the East where the pandemic toll is far lower."

Insights

Not all emerging markets are equally resilient

Since 2014, central bank action has driven negative-yielding debt to reach \$11 trillion by March 2020. The hunt for yield will intensify as rates remain even lower for longer. This has turned the spotlight on EM debt – but only selectively. We focus on companies, not countries.

South Asian economies like Indonesia and India are still struggling to contain the pandemic. India's was a lacklustre economy even before the crisis, with rising bad debts in the banking and infrastructure finance sectors. The rise of Hindu nationalism has sidelined its reform agenda.

Many EM countries will suffer as global trade plunges by 13% in 2020. Their state-owned enterprises like airlines and utilities will need bailouts. The remittances and tourism on which many countries rely have already been devastated.

In contrast, countries of North Asia – China, South Korea and Taiwan – have had low economic vulnerability and high medical preparedness. Indeed, China's renminbi-denominated bond market – the world's third largest – is attracting our assets, after Chinese bonds' recent inclusion in global benchmark indices. A 10-year

government bond offers 3% or more. In a world of negative rates, that feels close to miraculous. The growth in China is of the highest quality we have seen in years – driven by domestic demand and technological advances, going from smokestack to labtech.

We will invest in the EM debt of nations with low external debt, a healthy trade balance, fiscal room to support businesses, low reliance on energy and tourism revenues, and good social safety nets.

~ A Dutch pension plan

Known risks are overpowered by unknowable uncertainties

Covid-19 has yet again exposed the difference between risk that can be measured and uncertainty that cannot.

In a highly interconnected world, a viral outbreak at a Chinese wet market has exponentially escalated into the most unpredictable global crisis in living memory. An organism confined to a niche setting suddenly thrived in an ecosystem damaged by the uneven relationship between humans and nature. Once again, it confirms that some events are nigh-on impossible to predict, no matter how sophisticated our understanding of risk.

With the arrival of the second wave of the virus in many developed economies in the latter part of 2020, investors have little insight into the future. All that they can do is rely on more policy bazookas to reboot fragile capital markets. The recent steep and rapid downgrades of some commercial mortgage-based securities from triple-A to BB in the US shows the limits of the policy revolution described in the *Executive Summary*.

Today, markets are front-running the economy, with little sign of a catch-up. Conditions for strong directional risk exposure

are far from ideal. Investors are left to choose between two poisons: avoiding loss or missing opportunities. As a result, risk management will shift dramatically from a backward-looking formulaic approach to a forward-looking one based on experienced market intuition and extreme nimbleness. Trend is no longer destiny. And the odds are unknowable. Three risk tools will be widely used in this decade (Figure 3.2).

To start with, greater scenario planning will be the preferred approach (61%).

In practice, it means five things. First, preparing for alternative futures and deploying multiple strategies. Second, creating reference narratives or investment theses to guide investment decisions. Third, allocating time and resources to model events that may never come to pass. Fourth, building cross-disciplinary teams that are better able to spot underlying vulnerabilities and respond in a timely fashion. Finally, having a debating culture in which ideas generate new ideas and opinions shift in the light of new evidence. After all, in the dark, all swans could be black.

Conditions are far from ideal in which to have strong directional risk exposure.

Figure 3.2

What approaches will your pension plan use in order to manage risks in your portfolio when financial markets enter a new era after the crisis?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"A finance expert is about as accurate in predicting the future as a chimpanzee throwing darts at a target."

"Scenario planning means putting all our biases to one side and expecting anything and everything within limits."

Second, within scenarios, diversification will remain a massive cornerstone in investing – be it based on asset classes (55%) or risk factors (54%).

History shows that either type only works when underpinned by low correlations. As correlations are not static, it is vital to conduct scenario analysis to assess how they might fare in different situations.

The pandemic crisis has stress tested various business models. Companies with low leverage, comfortable cash buffers and a diversified range of customers and suppliers have proved more resilient so far. The crisis has also shown that choosing a good company is not just about a strong balance sheet and P&L statement. Companies need to pay attention to the wider environment in which they operate. They can only be as resilient as the society they inhabit. The virus has sparked a serious rethink on how companies do business (see [Insights](#)).

The third risk tool will centre on liquidity management (57%). The market plunge in March 2020 once again confirmed that liquidity is the most overlooked risk.

Even before the crisis, the Bank of England had warned that there was \$30 trillion tied up in hard-to-trade assets. One factor was regulation after the Lehman crisis: it prevented traditional market makers from warehousing risk in fixed income. Another factor was the falling quality of covenants in the riskier corner of credit markets where QE had forced investors up the risk curve in search of yield via convictionless trades under an illusion of safety.

Investing based on scenario planning requires investors to be fleet of foot. Bad news can instantly turn greed into fear. That requires liquidity buffers to exploit entry points while avoiding a liquidity trap if the outlook worsens. As they chase risky assets, some of our survey respondents will likely prefer to stay on the dance floor while the music is playing but hover close to the exit; some will prefer to hold 'dry powder' to buy distressed assets at a steep discount whenever bargains emerge. Some will prefer to do more frequent rebalancing around their strategic benchmarks.

Bad news can instantly turn greed into fear. That requires liquidity buffers to exploit entry points while avoiding a liquidity trap if the outlook worsens.

Interview quotes *"Stop-loss mechanisms designed to limit the pain only exacerbate it when markets dive. They can be very expensive too."*

"Focus on liquidity allows us to implement our views in real time, as markets have become more fragile."

Insights

Extreme events with outsized effects are becoming more common

The three market crashes since 2000 have taught us salutary lessons. First, risk does not necessarily generate returns, as equities have been outperformed by bonds over extended periods. Second, returns are time varying, as actual returns have diverged markedly from expected returns for most asset classes. Third, asset class correlations are asymmetric: low in the rising market and high in the falling market.

In hindsight, conventional probabilistic approaches to risk – based on historical price behaviour, value-at-risk or risk-free assets have proved more therapy than anything useful.

Like sand dunes, their foundations shifted with the changing winds from

extreme events that have been far more frequent than predicted by the models in use. They have failed to anticipate, for example, the five worst outliers among the 15 biggest drawdowns recorded by the FTSE All-Share index since January 1981.

Each of them has become ever more damaging with rising physical and technological connectivity in the modern world. Each has also increased the occurrence of 'fat tail' events that have very low likelihood but very high impact.

There are now more situations in which a single cause – a virus, an asset bubble, cybersecurity, geopolitical disputes – can have outsized effects.

Hence, we are augmenting our old risk tools with scenario planning that is more suited to capturing the inherent fragility of a deeply interconnected world that defies 'rear-view mirror' modelling. All the obvious hedges against stock-market volatility – Treasuries, gold, bitcoin and the VIX volatility index – stopped working this year. To get the necessary agility, we are also putting liquidity management and good quality assets at the heart of our investment process, and frequently stress testing them.

~ A Swedish pension plan

Market fragility is creating tailwinds for long-term investing

As we saw in Figure 1.3 in the *Executive Summary*, 77% of our respondents expect to be in an era of low prospective returns. 50% expect asset prices to reconnect with their intrinsic value and around 40% expect central banks to lose their potency in artificially inflating asset values and suppressing volatility. Central banks flooding the market with liquidity is unlikely to prevent insolvencies and defy an economic downturn. Hence, 40% see the need to extend the holding period of their assets.

Indeed, greater policy intervention risks accentuating the parasitic side of today's capitalism.

Thus, long-term investing may well gain traction – by necessity as much as choice. The current holding periods are shown in Figure 3.3. They are likely to rise in order for mean reversion to work while a fog of uncertainty has descended on the investment scene. But there are omens that the rise might be secular, since some aspects of current investing are now seen as undermining the dynamics of long-term value creation.

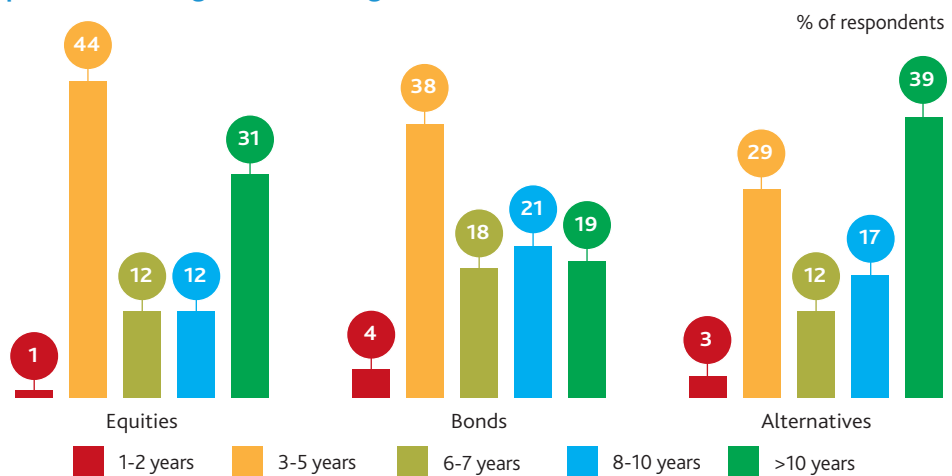
Active ownership via engagement with the investee company has been the dominant response among our survey respondents. In the past two years, there has been a growing concern that what passed as active management was simply the second-order trading of existing paper assets. Its main focus has been to try to anticipate the behaviour of other investors. The implied buying and selling of these assets has little to do with value

correction. It has only over-financialised the markets. This view is not only supported by the falling number of initial public offerings on both sides of the Atlantic, but also by the fact that most of the ones who do in fact come to the public markets have the principal aim of helping their owners to cash out rather than raise fresh capital for new growth projects.

Historically, the primary role of the equity markets has been to channel capital from savers to enterprises that want to grow their businesses. Savers were thus issued shares that were meant to provide a claim on the future profits of borrowers. But, over time, trading in such claims has itself become more profitable than the reward for holding them, giving rise to two other outcomes: vast growth in activity via derivatives trading and margin lending; and a weakening link between equity markets and the real economy.

In the current crisis, central banks have done what they had to do: pull out all the stops to prevent a 1929-style disaster and a prolonged market meltdown. While welcoming this decisive action, investors also know that there is no such thing as a free lunch. Of course, unusual times demand unusual measures. But that does not mean they will all work. Indeed, greater policy intervention risks accentuating the parasitic side of today's capitalism.

Figure 3.3 For operational purposes, which of the following time periods will define your pension plan's interpretation of 'long-term investing'?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"To live in a crisis is to live in a world that is temporarily up for grabs."

"The ecosystem of public equity markets is no longer conducive to long-term value creation."

In the European Union, there is a distinct change in sentiment currently, inspired by its second Shareholder Rights Directive.

In the last decade, despite its formidable arsenal, the Fed was powerless to force creditworthy households and businesses to borrow to create viable ventures for capital to invest in. The bang per buck of each extra dollar of stimulus has been falling in a perverse environment where inflation has gone from being a destroyer of financial wealth to a measure of economic health. It's hard to see how the Fed's recent purchases of fixed income securities can turn bad debt into good debt.

In the 1980s, only 2% of listed companies in the US were classed as zombies – not earning enough profit to pay even the interest payments on their debt. By the eve of the pandemic, the number had shot up to 19%. It casts doubt on markets' price discovery role.

Worse still, during the last business cycle, companies in the S&P 500 Index returned more than \$9 trillion to shareholders via share buybacks and outsized dividends – a sizeable chunk of the Index's \$23 trillion capitalisation. This was done mainly by leveraging their balance sheets. The resulting artificial boost to prices further disconnected them from their fair value. QE has left markets with a weak immune system.

The world went into the Covid-19 pandemic vulnerable to another financial crisis precisely because it had become so fragile and addicted to easy credit and generous bailouts to soften the impact of every crisis since the 1980s, while seeking to boost growth at any cost.

A growing body of research shows that such addiction has been a major contributor to many of modern capitalism's glaring ills such as low productivity, underinvestment in human capital and the rise of oligopolies via aggressive M&A practices. Instead, what is needed is a more focused policy approach that cushions the pain of recessions but encourages companies to stand on their own two feet thereafter.

In the European Union, there is a distinct change in sentiment currently, inspired by its second Shareholder Rights Directive. It aims to strengthen the role of shareholders, enabling them to act like active owners of businesses, not passive holders of paper assets. It's a new form of stewardship that bestows new rights, responsibilities and accountabilities on shareholders. The winds of change are evident. But the immediate path ahead is not so apparent (see [Insights](#)).

Interview quotes *"Low rates have raised fears about the insolvencies of pension plans and promoted short-termism."*

"The rise of stewardship on our part is forcing our investee companies to go beyond quarterly numbers and promote sustainability."

Insights

Long-term value creation vs short-term solvency

With multidecade liabilities, long-term investing is in our DNA. But central banks' quantitative easing has proved a big obstacle lately.

First, zero-bound interest rates have hugely inflated the present value of our future liabilities and trashed our funding ratio. Second, our bond portfolio no longer yields a decent income to fund regular pay-outs, forcing us to raid our capital base. Third, QE has brought forward future returns and ushered in an era of low prospective returns.

As a result, we have been under immense pressure to deliver good returns while QE has been pumping up

asset values. In the last decade, this was difficult due to the ever-present risk-on/risk-off cycles: asset prices went up in steps but came down in the lift. This elevated the sequence of returns risk: the time taken for the portfolio to recover after a big hit. It was no longer prudent to ignore it while our liabilities were maturing fast. Our priority shifted to retaining solvency.

QE is not the only factor behind rampant short-termism. A more deep-seated one is the structural malaise in the global economy – low growth, low productivity and rising inequalities. QE has hastened the long-term shift in income distribution in the West – from wages to profits – while economic

growth has been lacklustre. The rise of populism was inevitable.

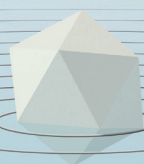
Governments have shied away from adopting the necessary reforms for fear of political fallout. Instead, they have overly relied on central banks to do the heavy lifting with little regard to the unintended consequences for savers and pensioners. Central banks cannot solve structural problems.

Long-term investing has never been so challenging and yet so necessary. The more we can look through the turbulence ahead, the more things will tend to work out.

~ A UK pension plan

4 ESG: the cornerstone of investing

What is the scorecard so far?



Overview

This section highlights:

- how the Covid-19 pandemic has hastened the tectonic shift towards ESG
- why ESG is seen as a credible tool for pricing the future into the present
- how ESG can help effect a 'just transition' to a low-carbon future.

Key findings

a. Tectonic shifts

The pandemic has given investors a real taste of how physical shocks can devastate portfolios.

ESG investing has proved resilient while targeting:

- good risk-adjusted returns as part of a double bottom line
- a more defensive portfolio that factors in fat-tail/far-off risks
- lower portfolio volatility.

Given its relative newness, long-term data are not yet available to test whether ESG is a risk factor.

But pension plans certainly see it as a credible source of 'social alpha', arising from valuation anomalies, while markets are slow to price in the newly emerging investment themes.

b. Pricing the future into the present

The market crash in March 2020 was a true test of whether ESG investing is purely a bull market luxury, lacking resilience against big drawdowns. Our survey shows otherwise.

For the overwhelming majority of our respondents, their ESG funds performed better than the rest of the portfolio (52%) or the same (45%).

ESG allocations are likely to rise over this decade due to:

- the harsh reality of major physical disasters such as wildfires and hurricanes, or spectacular corporate bankruptcies due to governance lapses
- tailwinds from major policy initiatives worldwide, but especially in Europe, and America. President-elect Joe Biden plans to push for the most progressive climate policy the US has ever had.

c. A just transition

The turbo-charged globalisation of the past 40 years created winners and losers.

But national governments in the West failed to re-equip and reskill those who suffered job losses and/or stagnant incomes, as the centre of gravity in global manufacturing shifted to the low-cost emerging economies.

Hence, pension investors are keen to ensure that as the global economy transitions towards a low-carbon future, its fruits are not unevenly distributed.

As social considerations are coming to the fore, the 'S' component in ESG will receive ever more prominence in the future.

"ESG has a role in our portfolio that extends well beyond ethical considerations."

An interview quote

The pandemic has hastened the tectonic shift towards ESG

The current crisis is a devastating reminder of the fragility of life on Earth. It has starkly exposed the toxicity of the relationship between humans and nature.

It has given investors a real taste of how physical shocks – unlike economic ones – can roil the markets and whipsaw pension portfolios at a speed once unimaginable. It has moved many of the old 'unknown unknowns' of climate change impacts into the realm of experience.

Two years ago, no major economy was committed to net-zero emissions. Now eight of the top 12 countries are: Canada, China, France, Germany, Italy, Japan, South Korea and the UK. The US will soon join under President Joe Biden.

As we saw in Figure 1.5 in the *Executive Summary*, the trend towards ESG investing, which had been gaining traction in the last decade, is likely to accelerate in this decade.

It has been reshaping the ecosystem of financial markets to factor in risks and rewards attached to the separate elements of environmental, social and governance investing. Measurable metrics – like P/E ratio, price-to-book and leverage – are being burnished by observable natural disasters such as floods, wildfires and droughts.

To pension investors, ESG is all about the double bottom line: do well financially and do good socially. In its early days, the emphasis was on the exclusion of 'sin' stocks associated with activities deemed unethical: tobacco, weapons, fossil fuels, abuse of human rights and poor labour standards. On the downside, negative screening curtailed the scope for diversification.

Since then, the emphasis has shifted to so-called *social alpha*. This is based on the belief that ESG investing is as much about picking winners as avoiding losers.

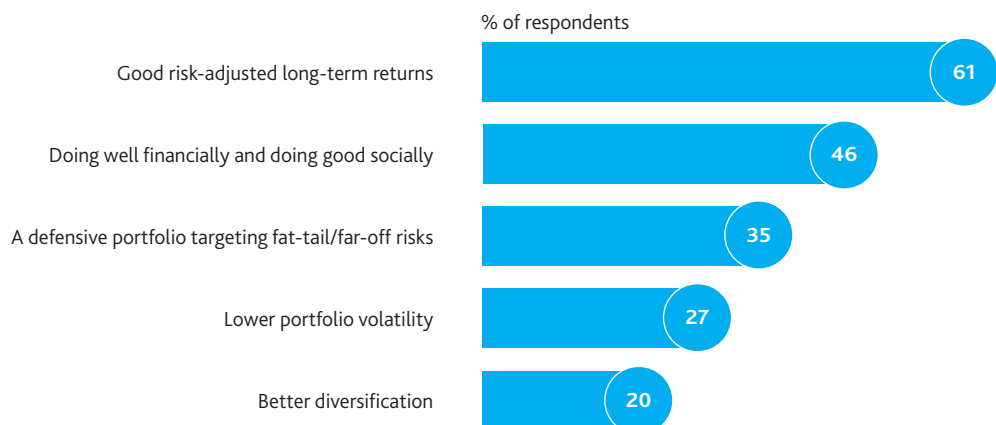
Hence, some pension plans have been adopting impact investing that overtly targets quantifiable social as well as financial outcomes.

Others have been overweighting companies whose ESG scores are likely to improve and underweighting laggards: this, in the belief that the markets will reward improving scores as they are priced in.

Either way, the aim is to prudently pre-empt ESG risks now rather than be forced to react dramatically when they materialise. This imperative underpins our respondents' approaches as they set out to seek a number of concrete benefits from their ESG investing (Figure 4.1).

ESG investing is as much about picking winners as avoiding losers.

Figure 4.1 What benefits do you expect your asset manager to deliver from your ESG investing?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"The dystopian reality created by the pandemic has shown how ESG can be material to business performance."

"Avoiding negative ESG scores has contributed 70% of ESG-related performance since 2018."

61% of them target good risk-adjusted long-term returns. Some of them believe that ESG is now a viable risk factor, with the exception of two caveats.

First, it is a compensated factor in Europe but less so in America and Asia. The 2015 Paris Conference on climate change was the turning point for European pension plans.

Second, they also believe that the individual performance of environmental, social and governance factors has not moved in lockstep over time, calling for a more granular approach.

Yet other respondents take a more pragmatic view, given that ESG investing has not prevailed for a long enough period to qualify as a risk factor (see [Insights](#)).

After all, more than half of the total carbon emissions in human history have occurred in the last 30 years. That has led some investors to capture 'social alpha' by investing in companies who are improving their ESG scores in ways that are throwing up price anomalies and buying opportunities.

Moving on, 46% are targeting a double bottom line: doing well financially and doing well socially. In addition to better financial performance, investors increasingly want to contribute to a better world.

Their approach rests on the view that as national economies have grown and progressed, new forms of business challenges have emerged. They are Janus-faced: they carry rewards as well as risks. With growing global connectivity, investors are exposed to fat-tail/far-off risks that are very hard to model statistically, given their unusual complexity. By seeking to manage them, therefore, ESG is now perceived as providing a more defensive portfolio (35%) and lower volatility (27%).

There is clear acceptance that ESG may not yet be a unique factor, since it is highly correlated with long-established risk factors such as quality and low variance. But it serves to reduce portfolio exposure to dynamic risks such as climate change, societal upheavals and governance lapses that can be highly material to business performance.

With growing global connectivity, investors are exposed to fat-tail/far-off risks that are very hard to model statistically, given their unusual complexity.

Interview quotes *"In 2017, 16 weather disasters in the US cost \$309bn. In the last decade, the cost from natural disasters globally amounted to \$3tn."*

"A crisis often accelerates change. This time is no different – especially in the ESG space."

Insights

ESG: A risk factor or social alpha?

Is ESG a risk factor? It all depends on your definition. To qualify, the definition of ESG should be consistent and robust across geographies, time and styles.

Unfortunately, ESG does not have a common definition. Its rating providers use numerous metrics when determining a company's ESG score. Furthermore, there are glaring inconsistencies in the ESG scores from different providers for the same companies. They tend to align more closely with investor wishes than a particular factor. Finally, the history of ESG data is quite short – about 11 years. Instead, only a multi-decade data series can test a factor's robustness.

Experience shows that ESG is a factor in Europe, but less so in America and Asia. But this is a second-order issue for experience also teaches us that analysing a firm's past financial numbers is akin to driving using only the rear-view mirror. The past is not a guide to the future. So, we look forward and factor in change, especially as markets are beginning to price in ESG factors.

This is classic thematic investing, following in the footsteps of other themes like robotics and healthcare.

We segment our universe of companies into three groups: those with a very high ESG score that is already priced in by the markets; those with poor scores that are

unlikely to improve; and those with low scores but a high likelihood of progress.

We target the last group to capture social alpha arising from material improvements in their scores; knowing that today's alpha could be tomorrow's beta.

Our ESG portfolio has beaten its benchmarks since 2015, even in periods of large drawdowns in 2016 and 2018, because we selectively target those ESG aspects that, in our view, underpin resilient businesses.

~ A French pension plan

ESG is about pricing the future into the present

Time will tell whether Covid-19 proves a watershed for ESG investing. The market plunge in March 2020 was the first test of this conviction (Figure 4.2).

52% of our respondents reported that ESG investments performed better than the rest of the portfolio. 45% reported that it did the same as the rest and the remaining 3% reported that it did worse than the rest. On the whole, ESG funds appeared to score better – in terms of returns and volatility – in all regions.

ESG characteristics have added to business resilience during the market meltdown in March 2020.

One contributory factor has been the relative underweight of fossil fuel companies like oil majors and coal mining. Yet another reason has been the fortunate sector bets with above-market exposure to high-flying sectors in different regions. Technology stocks have driven market recovery in the US and Japan. In Europe, the driver has been healthcare stocks, and in China, financials and tech sectors.

However, in all regions, the most important reason behind the reported resilience has been stock selection. It contributed more than sector allocation, according to our post-survey interviews.

It was, in part, driven by a raft of material – albeit intangible – sustainability factors like employee job satisfaction, working conditions, community engagement, customer relations

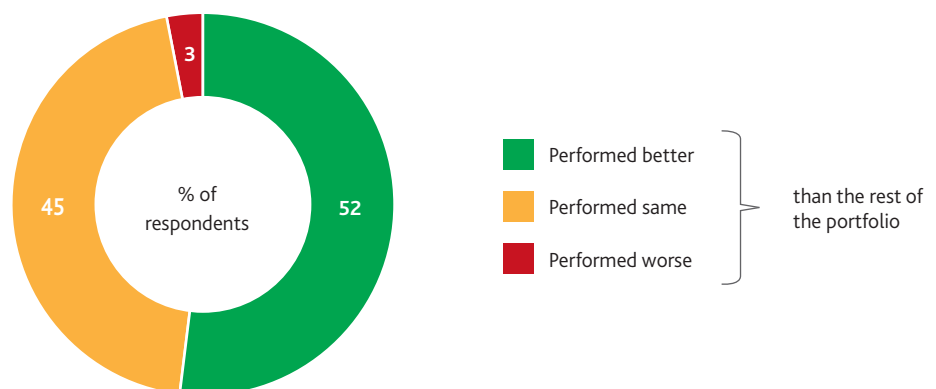
or board effectiveness. ESG characteristics added to business resilience during the market meltdown in March 2020. Indeed, our data lend support to published data by Morningstar showing that the long-term performance of the majority in a sample of 745 Europe-based sustainable funds have done better than non-ESG funds over one, three, five and ten years. Most notably, they have done better in periods of big drawdowns. Thus, they are winning more by losing less (see [Insights](#) on the next page).

As we saw in Figure 1.5, in the *Executive Summary*, 82% of our survey respondents expect to 'increase' their ESG allocations over the next 3–5 years, 18% expect the allocations to 'remain static' and 0% expect to 'decrease' them. The implied resilience of these funds is one factor. The other is fresh tailwinds from policy initiatives after various catastrophic events worldwide.

On the climate front, recent examples include wildfires in California and Australia, heavy precipitation and flooding in the Midwestern US, extended drought and water scarcity in the Middle East and successive hurricanes in the Caribbean and Gulf of Mexico.

Similarly, on the governance front, four spectacular blue-chip disasters have shaken investor confidence: BP's Deep Horizon

Figure 4.2 Which of the following statements applies to your ESG investments since the market dislocation in March 2020?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"What Covid-19 has shown is how health and environmental issues can become a profound social and economic problem."

"The resiliency of sustainable investing has been evident by its good relative returns and low volatility in this crisis."

oil spill in the Gulf of Mexico in 2010, Volkswagen's emissions scandal in 2014, the Petrobras bribery scandal in 2016, and the Wirecard fraud in 2020.

The most prominent policy responses have included the EU's taxonomy on green finance, its 2019 Shareholder Rights Directive II and its Green New Deal, allocating €225 billion to achieve its 2030 climate targets. The EU's latest initiative on delivering two landmark benchmarks for equities and corporate bonds has been widely welcomed.

The first of these – called *The Paris-Aligned Benchmark* – targets a 7% year-on-year reduction in carbon emissions plus a 1.5°C limit to global temperature rises by 2050. It excludes fossil fuel companies. The second one – called *The Climate Transition Benchmark* – has similar targets but permits fossil fuel investment in the transition process. Notably, unlike previous benchmark models, these will be overseen by the regulators. Major index providers are now exploring ways to onboard them.

For its part, the new Biden Administration has pledged a \$1.3 trillion infrastructure programme, with a strong focus on green

energy. Against that, however, in the US, lately, there has been a growing backlash against pension plans as ESG stewards. The latest proposal from the Trump government had threatened their ability to incorporate ESG principles into their DC portfolios. But the win by Joe Biden in the November 2020 US presidential election will be hugely consequential. He aims to drop the proposal as a part of the most progressive climate policy the US has ever had.

Elsewhere, ESG investing has been gathering momentum in the past five years. This has become evident from a recent steep rise in the price of carbon credits to €30/ton, while fundamentals imply €20/ton. This is its highest value since 2006.

Even in a fossil fuel rich economy like Australia, efforts to address climate change risks in the superannuation industry have intensified in the third quarter of 2020, with about one-fifth of the 20 largest pension funds publicly committing to achieving net-zero emissions in their portfolios by 2050.

ESG investing has been gathering momentum in the past five years.

Interview quotes *"In the past 10 years, onshore wind energy prices fell 70% and solar photovoltaics 89%. They no longer need public subsidies."*

"Firms are becoming aware that they need a social licence to operate. The old ways are now unacceptable to their customers."

Insights

Covid-19 firing interest in green bonds

Initiated in 2007, the green bond market now holds over €700 billion in assets. The record €200 billion issuance in 2019 is expected to be surpassed by a new high of €300 billion in 2020. They first took off after the launch of the Green Bond Principles in 2014 and the €14.8 billion French sovereign green bond in 2017.

That paved the way for sizeable sovereign issuance from Belgium, the Netherlands and Ireland as well as several emerging sovereigns such as China, Nigeria and Indonesia.

Their proceeds have been allocated to renewable energy, green buildings and transportation. This market is

set to gain a fresh boost from two sources, as the current crisis pushes the sustainability agenda to the fore.

First is the new EU taxonomy adopted in 2019, which clearly lays out much-needed definitions and minimum standards. Second is the UN Sustainable Development Goals, which will require annual financing of \$3–5 trillion by 2030. Much of it will come from the private sector.

The recent data bode well. The Barclays MSCI Euro Green Bond Index has outperformed an index of euro-denominated corporate and sovereign bonds since 2016.

In 2019, our green bonds delivered returns of 7.4% compared with 6% for regular bonds. It shows that investing in green bonds does not compromise performance.

Indeed, we expect a further boost as the European Central Bank includes green bonds in its new QE programme. This seal of approval will also hasten reforms in the market infrastructure around green bonds.

~ A German pension plan

The success of ESG rests on a 'just transition'

Pension plans are now adopting a holistic investment approach where ESG factors sit beside financial ones, such that assets are managed from a total return perspective. At this early stage in their history, ESG factors are already seen as conveying information about the looming risks that cannot be captured by the existing backward-looking risk models. This is exemplified by the fate of the current large reserves of fossil fuels. As the global economy transitions towards a low-carbon future, these could be abandoned as stranded assets well ahead of their economic life, causing social hardship in local communities.

This example underlines an important trade-off between 'E' and 'S' factors as the demand for fossil fuels falls. Not surprisingly, therefore, when asked to single out the most important factor, our survey respondents provided a more balanced perspective (Figure 4.3).

The social factor (30%) has now risen and the environmental (41%) and governance (29%) factors have fallen somewhat in relative importance since our 2018 Survey. For long the ignored middle child of ESG, the 'S' factor has come into its own in 2020 as Covid-19 has exposed low wages, precarious jobs and labour exploitation in frontline occupations in various economies – especially in the retail, transport and medical industries. The spotlight

has been turned on the notion of 'social licence to operate' in general and how global firms manage their supply chains in particular.

Minimal inventory and the complexity of supply chains have effectively enabled them to externalise social costs to low-wage developing nations with poor labour standards and environmental records. This aspect of globalisation is now harder to defend in a world that has suffered the collective hardship of the coronavirus. For sure, the model has lifted over 700 million people out of poverty in the developing world, especially India and China, while delivering lower prices for goods and services in the Western economies.

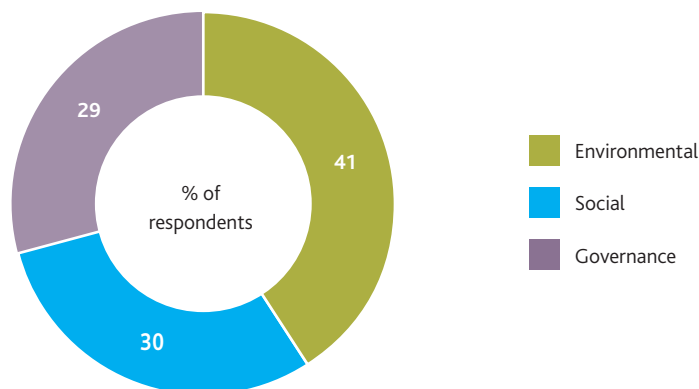
This virtuous cycle has lately come to an end as global trade is stalling, productivity is stagnating and direct investment levels remain low. As a side effect, the cycle has long inflicted pain in the developed world via a hollowing out of middle-class jobs, stagnant real incomes and the loss of skills, as jobs moved to low-wage economies.

The transition has not been just. The losers in this cycle have often not been effectively compensated for their loss via new job opportunities or income benefits or occupational reskilling. Thus, globalisation has shared one common feature with the rise

For long the ignored middle child of ESG, the 'S' factor has come into its own in 2020.

Figure 4.3

When considering ESG investment for the longer term, which component do you consider to be the single most important one?



Source: Amundi Asset Management/CREATE-Research Survey 2020

Interview quotes

"Going from a just-in-time supply chain to a just-in-case supply chain will cause a big upheaval."

"We hold our asset managers accountable for more than just financial results."

of artificial intelligence. Both have delivered benefits in the West. But such benefits have been accrued to many in their role as consumers, not as workers or citizens. This renewed focus on a 'just transition' to more sustainable societies has turned attention on two areas.

One is well-known data deficiencies. There is no universal agreement on what constitutes a 'good' company in practice. Hence, with few exceptions, governments do not mandate firms to provide data on their ESG practices within a consistent scheme. Investors are thus forced to use different definitions from over 150 data vendors worldwide. Their proprietary scoring methods often give radically different assessments of the same company.

To make matters worse, these vendors have yet to develop a robust methodology on two key issues: materiality and intentionality. One seeks to assess which factors really matter to a firm's business performance; the other seeks to find out whether the firm actually does 'good' via its products, services and interactions with the wider community. Hence, data vendors have been under pressure to up their game.

The other area receiving attention is stewardship that fosters better dialogue with investee firms to achieve the targeted ESG outcomes. This is deemed to offer a better model of capitalism with its focus on purpose, inclusion and engagement. Ever more pension plans are either directly – or indirectly via their asset managers – stepping up their engagement activities (see [Insights](#)). As a coalition, they persuaded Royal Dutch Shell to halve its carbon footprint by 2050 and link its emission target to the compensation of the company's senior executives. BP and Glencore followed suit soon thereafter. The underlying idea is that firms that are part of the problem can also be part of the solution. The biggest carbon emitters have the greatest capacity for improvement.

Most businesses no longer deny the inconvenient truths of global warming or societal inequality. The winds of change are evident.

Stewardship offers a better model of capitalism with its focus on purpose, inclusion and engagement.

Interview quotes *"Paying lip service to stewardship is no longer possible in the face of regulatory pressures."*

"We have made global warming a key agenda item in engagement with around 1,100 investee firms this year."

Insights

From box-ticking to narrative engagement

The 'fake it until you make it' mentality is over. Investors have wised up to greenwashing in ESG funds: shortcuts taken by some asset managers to repurpose their old funds with an ESG label without rejigging their investment process.

External data vendors use inconsistent definitions of good and bad ESG companies. Hence, for us, alpha generation is no longer just about relying on their scores. We use a more targeted approach.

First, our thematic investing avoids the whole ESG universe. Instead, it hones in on narrower and more unified groups of topics of interest to us – like

low carbon, gender equality, improved labour standards and better corporate governance. Second, as shareholders and debtholders, we have the potential to drive change for the better via AGM voting or direct engagement.

That means knowing the ESG topics that are material to our investee firms and having a year-round constructive dialogue with them. In some industries – like oil and gas – the issues are clear cut. In others, issues like child labour and weak governance have normative dimensions where progress requires a long-term focused dialogue based on specific targets, the actions required to meet them and their outcomes,

both measurable and observable. This form of narrative engagement holds management to account for their actions as well as their outcomes.

Last year, we rejected a record 1,575 board-level agenda items. The reasons varied from the lack of independent board members and workforce diversity to the lack of proactive oversight of environmental and social risks.

~ A Danish pension plan

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^[1] Source: IPE "Top 500 Asset Managers" published in June 2020, based on assets under management as at 31 December 2019

^[2] Boston, Dublin, London, Milan, Paris and Tokyo

^[3] Amundi data as at 30/09/2020

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