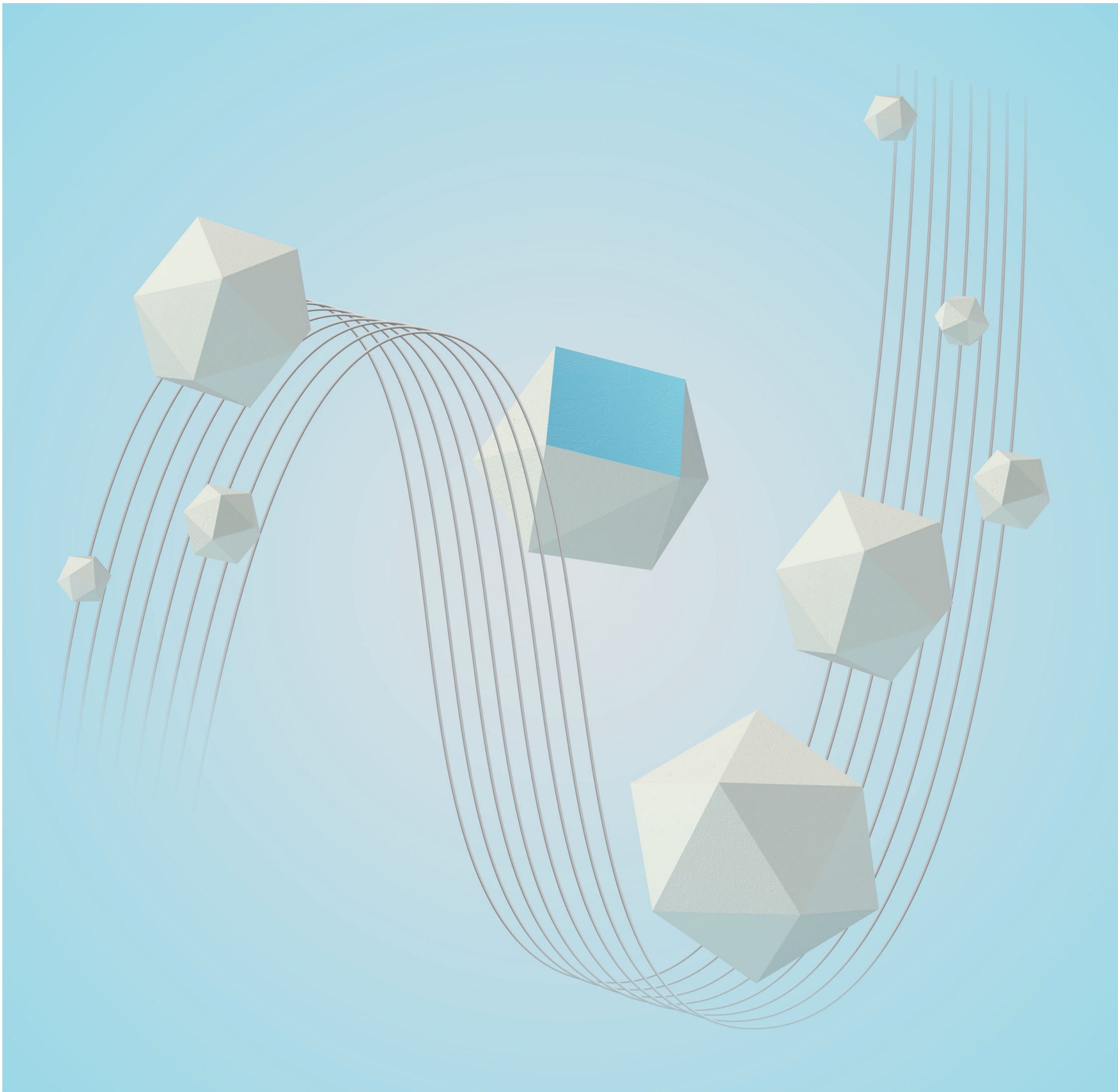

Rocky Road for the European Union: Pension Plans' Response

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Amundi
ASSET MANAGEMENT

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Foreword

Once again, Amundi and Create-Research have partnered in the Annual European Pensions Survey to provide invaluable insight on what pension plans are thinking and how they are faring in today's complex market environment.

Political risks and the rise of populism (Italy, Brexit) are symbolic of fading trust in the European Union as an institution. The robust long-term structural political unity for which it was designed has yet to be achieved. It seems that the EU is missing an opportunity to carry out the structural reforms that would enable it to shape its role of stability, unity and protection for the region in line with the rapidly changing challenges of today's world.

As many countries are beginning to pull away from the post-financial crisis era, unconventional monetary policies are coming to a close. But following the optimism fuelled by the recovery experienced last year, the European economy has slowed to mediocre performance this year as it has become weighed down by external factors, notably political.

Political risk has gone from being a short-term disturbance to taking centre stage in a more fragile economic and financial market. Long-term risks emanating from global tensions related to trade agreements, the migration crisis and ongoing uncertainty surrounding Brexit all pose major challenges for the economy and now dominate. The challenge for investors is how to integrate this into the investment process.

Moving forward, investors can expect increased volatility as we accept that in the event of another recession, central banks can no longer play the monetary policy card so effectively. The exceptionally low interest rate environment is set to prevail, leading to lower returns in equity and bonds. Investors are struggling to find signposts to where to seek good returns, except perhaps for India, where growth is still on an upward trajectory.

In the future, investors will be forced to rethink their approach, to adapt and redraw frontiers. The traditional walls of investing should be knocked down to give way to a fresh approach, where innovation will be key.

In the fixed income universe, we see rising demand for an alternative approach using opportunities to be found across the full credit spectrum from Investment Grade to High Yield, from public to private debt markets.

In equity markets, it will be important to take a pragmatic approach with risk at its core. Amid high volatility, investors can expect lower returns and must look beyond traditional diversification as a way to capture performance. Instead, the story will be about a move to risk factor investing.

But among all the pointers provided by this report, responsible investment shines through as a mainstream requirement. Investors, in particular pension funds, are affirming their expectations loud and clear for long-term sustainable investments to be an integral layer in their portfolio management. ESG can no longer be overlooked, not only from a long-term performance angle but also from a long-term risk management perspective.

Amin Rajan has once again crafted an excellent overview of where pension plans are right now and the difficulties they face as they move into a new phase. We hope you enjoy reading the report.

Pascal Blanqué

Group Chief Investment Officer
Amundi

Acknowledgements

"We must reform in order to conserve."

Edmund Burke, Irish Statesman

Institutions lose relevance in a changing world, unless they reform and adapt. That's the prospect faced by the European Union, after its lack lustre growth since the 2008 global financial crisis.

This survey report reveals how pension plans view the prospect of much-needed reforms in the EU, as they face new risks that require concerted action.

This survey report reveals how pension plans view the prospect of much-needed reforms in the EU, as they face new risks that require concerted action.

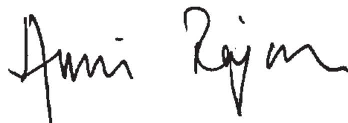
My foremost thanks go to those 149 pension plans who participated in our survey. They provided invaluable insights into the forces driving the markets over the rest of this decade and their impact on asset allocation. Over the years, their unstinting support has enabled us to highlight the changing dynamics in the global pension landscape.

I would also like to thank Amundi Asset Management for sponsoring this annual publication. Their arm's-length support has helped to create an impartial research platform that is now widely used in all pension jurisdictions.

Special thanks also go to IPE for their help in conducting surveys for this annual series and to its editor, Liam Kennedy, for his advice and encouragement over the years.

Finally, I want to record my sincere appreciation to two colleagues who have assisted in managing the survey, analysing data and providing meticulous editorial support: Dr Elizabeth Goodhew and Lisa Terrett.

After all the help that I have received, if there are any errors or omissions in this report, I am solely responsible.



Amin Rajan

Project Leader
CREATE-Research

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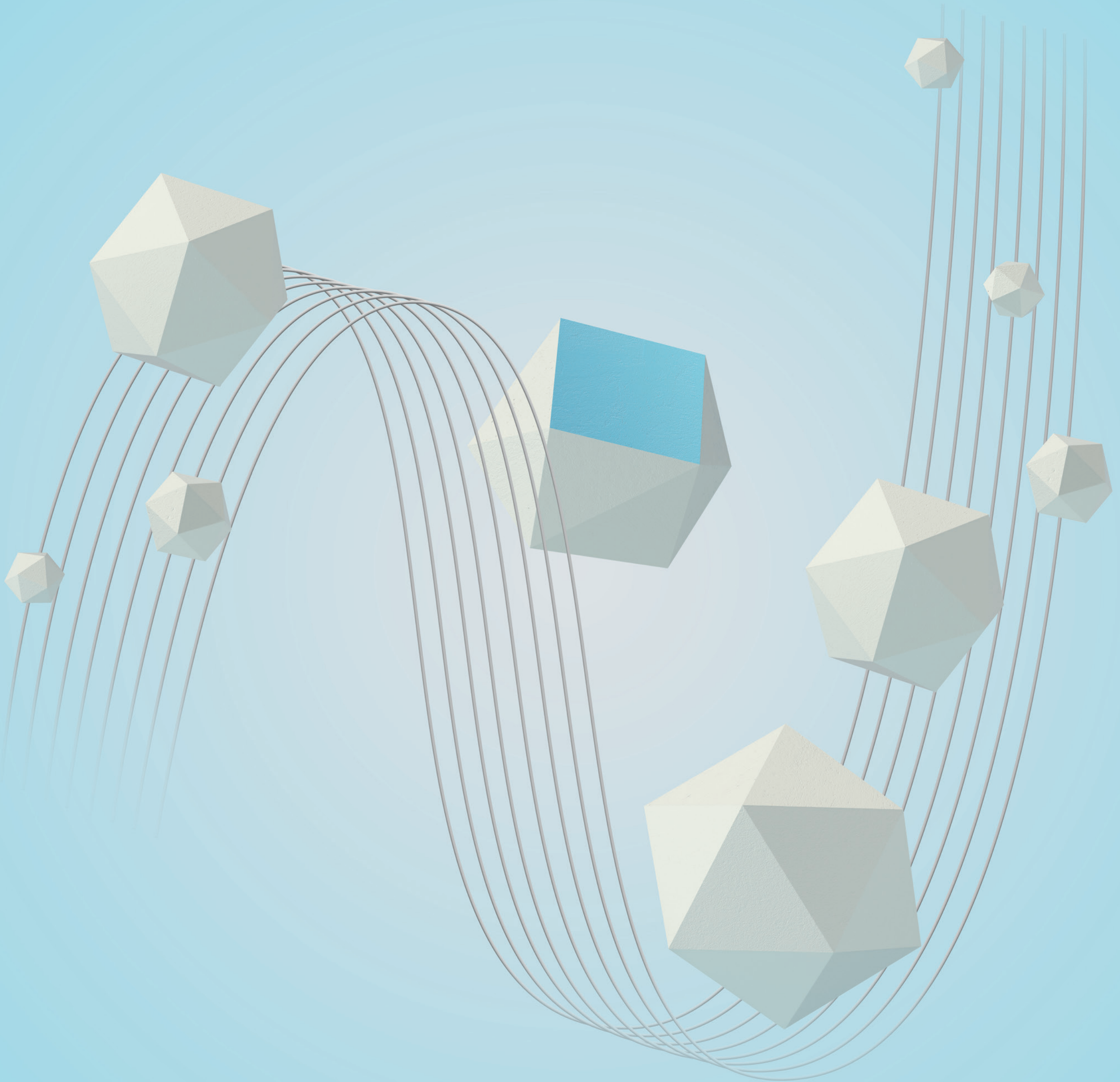
1 Executive summary



Introduction and aims

"The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function."

F. Scott Fitzgerald

Author of *The Great Gatsby*

Cyclical recovery or secular healing?

That's the big question behind the European Union's economic bounce after its 'lost decade': the toughest period since its inception in 1957.

Last year, its economy finally joined the growth party as part of the most synchronised global expansion since the 2008 financial crisis.

It lifted the spectre of secular stagnation, manifested by spiralling debt, runaway deficits, ageing demographics, rising unemployment and anaemic growth.

The 2016 Brexit result was a vote of no confidence on the part of one nation's citizens. Such an anti-globalisation backlash has been vivid in other member states too; as is the distrust of politicians and political institutions.

Anti-migration sentiment has been all too virulent – as shown by the latest election results in some member states.

However, with the recent economic revival, there is some anticipation that the EU's political and business leaders will take action to create fresh dynamism to improve business competitiveness and citizens' wellbeing.

For European pension plans, this is an important issue: the majority of them tend to have a strong home-region bias in their investment choices.

Moreover, the latest regulation designed to protect banks in Europe and the US has not eliminated risk from the global economy. It merely transferred it from banks to investors by pushing them into risky assets via zero-bound interest rates. Like a waterbed mattress, pressure applied in one place just moves the contents elsewhere.

The latest wave of tit-for-tat tariffs in a new 'cold war' between the US and China will also have added ramifications.

These new sources of risk have sparked interest in whether the long-awaited institutional reforms in the EU are likely to be implemented so as to minimise damage in the next downturn. After all, in this beggar-thy-neighbour world, the chances of the G20 countries uniting once again against a new crisis are slim.

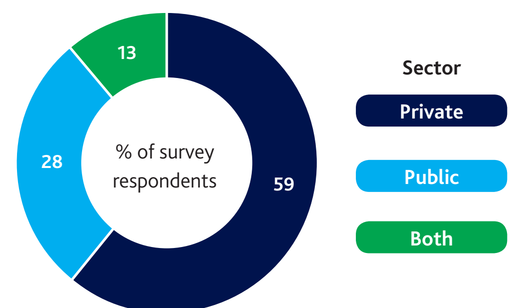
Accordingly, our 2018 annual survey has pursued the following questions:

- has the EU economy finally turned a corner after the prolonged calamity inflicted by the 2008 crisis?
- what further actions will promote the healing process?
- what new risks are likely to arise and how will they affect the asset allocation of pension plans?
- how will the latest IORP II Directive (Institutions for Occupational Retirement Provision) affect the European pension landscape?

These questions were pursued in a survey of 149 pension plans across the EU with total assets of €1.89 trillion, backed up by interviews with 30 of them (details in the figures below).

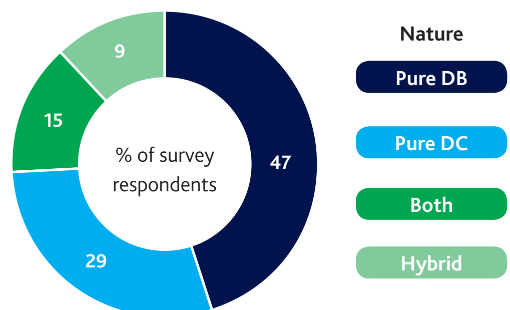
Our headline findings are presented on the next two pages, followed by six themes that expand on them.

Sectoral breakdown of respondents



Source: Amundi Asset Management/CREATE-Research Survey 2018

And the nature of their plan



Source: Amundi Asset Management/CREATE-Research Survey 2018

Headline findings

1. The EU's current recovery is more cyclical than secular

The European Union is recovering after its 'lost decade'. But 78% of our survey respondents think it is more of a cyclical bounce, while 22% think that the EU has reached the escape velocity that cuts it loose from its deflationary mindset.

Last year's palpable optimism has since dissolved into worries about the rise of populism in many member states.

One of its latest strands in Italy seeks to square expensive election promises with the fragility of its public finances. It risks breaching the EU's *Stability Pact*, threatening the very survival of the euro.

Progress has always been a matter of chaotic play – coming in fits and starts – instead of a grand design.

The Italian situation is symptomatic of the EU's deep-seated structural malaise: inefficient labour markets, subdued physical investment and glaring productivity gaps between core and peripheral states.

European companies are hoarding cash due to lack of opportunities as much as the fear of another economic shock.

The series of eurozone crises that came in the wake of the Lehman collapse has not been used to tackle the long-standing vicious cycle of institutional and policy inertia. This stands in the way of bold reforms, according to 59% of respondents. The immediate result is the distrust of politicians and political institutions (46%).

The root cause of these problems is that monetary union without fiscal union defies economic and political logic. Attempts to bridge the gap have been weakened by the EU's failure to respond in concert to the 2008 crisis. This has undermined the solidarity that drove the member states to ever-closer union in the preceding half century.

Themes 1 and 2 provide further details (pp.5-6)

2. The EU needs a new narrative to tackle its lingering fragility

At best, the EU is a half-built house. Finishing that job requires an updated narrative for the 21st century, as the savage wars of the last century that drove the creation of the EU fade into history. Today's generation wants benefits that apply to today's world. That requires concerted action to achieve three key goals.

The first is a clear vision of where the EU is heading, with a concrete action plan, including timelines (58%).

The second is fresh traction behind strengthening the Monetary Union and the Capital Markets Union (52%).

And third is improvements in social welfare that reduce income inequalities and enhance worker skills in this age of accelerated technological change (50%).

When asked whether the necessary actions will be taken over the next three years, views are very divided (Figure 1.0, left chart, next page): 23% of respondents think it 'very likely', 36% think 'maybe' and 35% think it 'very unlikely'. Uncertainty is rife because both Brexit and the latest migration crisis have sidelined essential reforms. There are expectations of fresh action.

After all, the Euro Barometer polls consistently show that EU membership remains very popular even in countries whose leaders regularly lambast it, like Hungary and Poland.

As a result, 35% of our respondents still see Europe as 'very likely' to remain an attractive place for decent returns. 47% think 'maybe' and 9% think it is 'very unlikely' (Figure 1.0, right chart).

Behind these dry numbers lies our key finding: for all its problems, it would be unwise to write off the EU. Its progress has always been a matter of chaotic play, not grand design. Populism has imposed a warped trajectory.

Theme 3 provides further details (p.7)

3. Booming markets are in the rear-view mirror

The ensuing uncertainty about the future of the EU will remain a big risk factor at a time when new risks are also arising from: the unwinding of the crisis-era quantitative easing by central banks; the escalating 'America First' vs 'China Dream' trade dispute; and rising inflation, as populism drives up both employee wages and supply chain costs.

Thus, pension plans' worries go well beyond the realm of a maturing business cycle. They now anticipate a low-return/high-volatility era in which investing will remain a relative value play where a formulaic approach like the 60:40 equity–bond no longer works.

Pension plans' worries go beyond the realm of a maturing business cycle. They now anticipate a low-return/high-volatility era.

Asset prices are now decidedly in the late cycle phase, with US markets already jittery. Asset allocation, hence, will have a selective focus in its three core areas.

The most favoured asset classes – shown in Section 2 – will be global equities (64%), infrastructure (58%), private equities (49%), EM equities (46%), and European equities (44%).

The most favoured allocation tools – shown in Section 3 – will be risk factor investing (58%), uncorrelated absolute return investing (53%) and alternative risk premia investing (48%).

The most favoured themes – shown in Section 3 – will be real assets (62%) bank restructuring, favouring private debt (43%), and ESG (51%). The latter is already fast going mainstream.

Themes 4 and 5 provide further details (pp.8-9)

4. IORP II will jump-start the long overdue consolidation in the EU pension landscape

In the emerging low-return environment, consolidation is likely to accelerate in order to drive out structural inefficiencies arising from duplication.

Hitherto, differences in regulations have obliged pan-European employers to run a multiplicity of plans in different pension jurisdictions. The IORP II Directive, due to be adopted by most member states by March 2019, is expected to start the drawn out process of harmonisation.

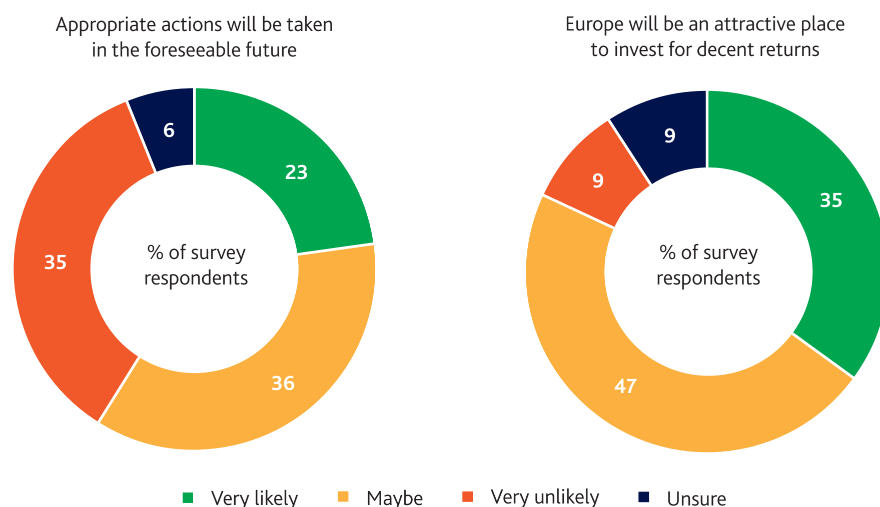
As shown in Section 3, 24% of our respondents are already implementing it, 16% are close to decision making and the remaining 60% are still in the awareness-raising stage.

The Directive is expected to generate four distinct benefits: improved governance and oversight; greater mobility of workers; economies of scale; and improved asset allocation, risk controls and member communication.

Its main impact will result in better asset allocation capabilities by pooling them as well as by attracting the best talent. The fragmentation in the past has conspired against a critical mass of capability that could capitalise on the various investment innovations of this decade.

Theme 6 provides further details (p.10)

Figure 1.0 **Taking a three-year view, how likely are the following statements about the EU?**



Source: Amundi Asset Management/CREATE-Research Survey 2018

Theme 1 The recent recovery is merely work-in-progress

A decade after the global financial crisis, uncertainty is holding back investment and confidence.

Nearly 4 out of every 5 respondents to our survey 'agree' that the recent recovery in the European Union is cyclical and fuelled by synchronised global growth. Only 9% 'disagree' with this proposition (Figure 1.1).

Within this overall assessment however, there are divergent views that reflect a high degree of uncertainty.

For example, whilst 33% 'agree' with the proposition that Europe still suffers from deflationary bias due to its debt, deficits and demographics, just as many also 'disagree' with it.

Such divided views are corroborated by two further responses.

While 25% of respondents 'agree' that Europe has finally healed after the 2008 crisis, 30% 'disagree'.

Such division is also evident when asked whether the current recovery marks a secular improvement brought about by improved competitiveness: 22% 'agree', while 31% 'disagree'.

However, there is agreement on one point: growth in the global economy has been a critical driver of European recovery, according to our interviews.

Beyond that, a notable minority believe that the recent recovery also reflects secular improvement in the growth engine. Europe may well have reached the escape velocity that allows its economy to cut loose from its deflationary mindset.

They argue that while the self-healing powers of the economy are re-emerging after being dormant in this decade, they also worry about the rise of populism in countries as diverse as Austria, the Czech Republic, Italy, Germany, the Netherlands and the UK.

For example, the latest strand of the populist wave in Italy has the potential to derail the euro project and halt the march towards further integration in the EU.

A decade after the global financial crisis, uncertainty is holding back investment and confidence. European companies are hoarding cash due to the lack of opportunities as much as the fear of another economic shock.

They also worry about the rise of anti-globalisation sentiment and have lingering doubts about the future shape and direction of the European Union itself.

No wonder the eurozone economy has experienced a slowdown in 2018 after a headlong expansion in 2017. It grew at 1.1% in the first half of this year while the US economy grew at 4.1% – in part fuelled by big tax cuts and spending rises.

Figure 1.1 How do you view the recent recovery in the European Union's economy?

Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"The EU is neither a half-empty nor a half-full glass. More a work-in-progress."

"For every one person who thinks that the EU is making progress, there is another one who thinks the opposite."

Theme 2 Lack of political leadership is holding back progress

Setbacks have not been used as an opportunity to tackle the long-standing issues that have conspired against economic dynamism and social progress.

A number of factors have contributed to slow economic and social progress in Europe. Running through them is a common thread: failure of leadership.

In the first seven years after the Lehman collapse in 2008, the European Union stumbled from one crisis to another and the response has been small and piecemeal to the point where it presented an existential threat to the very survival of the euro, as evidenced in the Greek debt crisis of 2011–13.

In fact, such setbacks have not been used as an opportunity to tackle the long-standing issues that have conspired against economic dynamism and social progress. Many barriers came in the way as part of a vicious cycle (Figure 1.2).

The principal barrier is institutional and policy inertia, which rules out the bold and necessary reforms (cited by 59% of our respondents). A further 48% think this is because of a lack of clear vision about Europe's future and 42% cite lack of consensus on integration among the EU's political leaders. This circular process has created distrust of politicians and political institutions (46%) and promoted populist sentiment (36%).

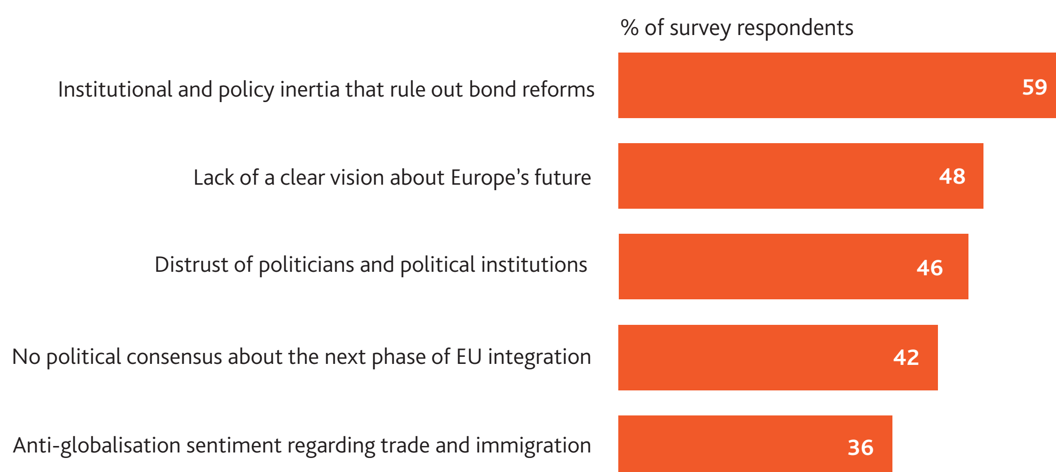
A good illustration is provided by the current situation in Italy. The new coalition government wants a fiscal boost in excess of €100 billion to reboot the economy after 18 years of stagnant output since joining the euro in 2000.

But this would blow holes in the EU's *Financial Stability Pact*, which forbids budget deficits and national debt beyond specified ceilings. Members of the eurozone have a common monetary policy under the auspices of the European Central Bank, with no significant fiscal harmonisation that would help member states who fall into difficulty. Austerity is their only option. But this has proved self-defeating in this decade.

The stark truth is that political leaders have not put the single currency on a more secure footing by implementing the various reforms that would permit greater convergence between eurozone member states, as envisaged with the introduction of the euro in 2000.

As a result, there is reluctance on the part of national authorities to pursue genuine European solutions to the common problems they face: large deficits, mounting debts, sagging productivity and lack of innovation. The reform agenda needs a second wind.

Figure 1.2 Which factors are currently inhibiting economic and social progress in Europe?



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"Under populism, the key political skill is the ability to harvest resentment among voters."

"The French president's authority is sagging just when Europe needs it so badly."

Theme 3 The EU needs a clear vision and a practical action plan

The UK's departure offers yet another opportunity to set a vision of what the EU wants to be.

Since the Brexit vote, one thing is clear: those disenchanted by globalisation are also among those with little faith in the EU and its various institutions.

The UK is not leaving a fully developed entity, but one that is evolving. The UK's departure offers yet another opportunity to set a vision of what the EU wants to be. A new vision is vital to retain the EU's relevance in an age where memories of the bloody wars that prompted its creation are slipping into history.

The latest French plan to promote fiscal union – a European Finance Ministry with its own budget to help economies in difficulty – shows no sign of gaining traction. Attempts to build a banking union that breaks the familiar bank/sovereign vicious cycle – 'the doom loop' – are also slow to emerge. Its bail-in provisions for failing banks lack both consistency in implementation and the resources for recapitalising failing banks. Likewise, progress on the European Deposit Insurance Scheme and the Capital Markets Union is piecemeal.

When asked what will revitalise the European economy, at least 2 out of every 5 respondents cited five actions to achieve three aims (Figure 1.3).

The first one is to have an overarching action plan with a road map of where the EU is heading in the foreseeable future – duly setting out the reforms, priorities, accountabilities, regulatory certainty and timelines.

The second aim seeks to create fresh momentum for strengthening the Monetary Union and the Capital Markets Union to improve the economic resilience of the member states.

The final one is about reducing the 'trust deficit' in politicians and political institutions by improving social welfare, reducing income inequalities and improving employability in this age of accelerated technological change.

Figure 1.3 **Which of the following actions will revitalise the European economy?**

Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"For the first time since 2007, central banks will not be able to act as circuit breakers in a crisis, after exhausting their policy ammunition."

"When the next recession comes, it is hard to see how the EU can mount concerted action to minimise the economic pain."

Theme 4 The low-return high-volatility era is here

The future of Europe is not the only factor weighing on our respondents' minds. They also worry that, by artificially inflating asset values, QE has borrowed against future returns, turned investing into a relative valuation game and suppressed volatility.

In the past 24 months, the volatility of the MSCI World index has averaged at half its historic norm. After a prolonged run, markets are in late-cycle phase.

Pension plans will continue doing a delicate balancing act between caution and opportunity.

Taking a three-year view, therefore, five factors are expected to drive returns, as shown in Section 2: the unwinding of QE (cited by 54% of our respondents), a new wave of tit-for-tat tariffs (53%), global growth (49%), the rising level of global debt (44%), and fears about the return of inflation (40%).

The net outcome of these drivers will be lower returns and higher volatility. Pension plans will continue performing a delicate balancing act between caution and opportunity. Accepting, on the one hand, that future returns for most assets will be lower; and minimising, on the other hand, the regret of missing a once-in-a-generation bull market.

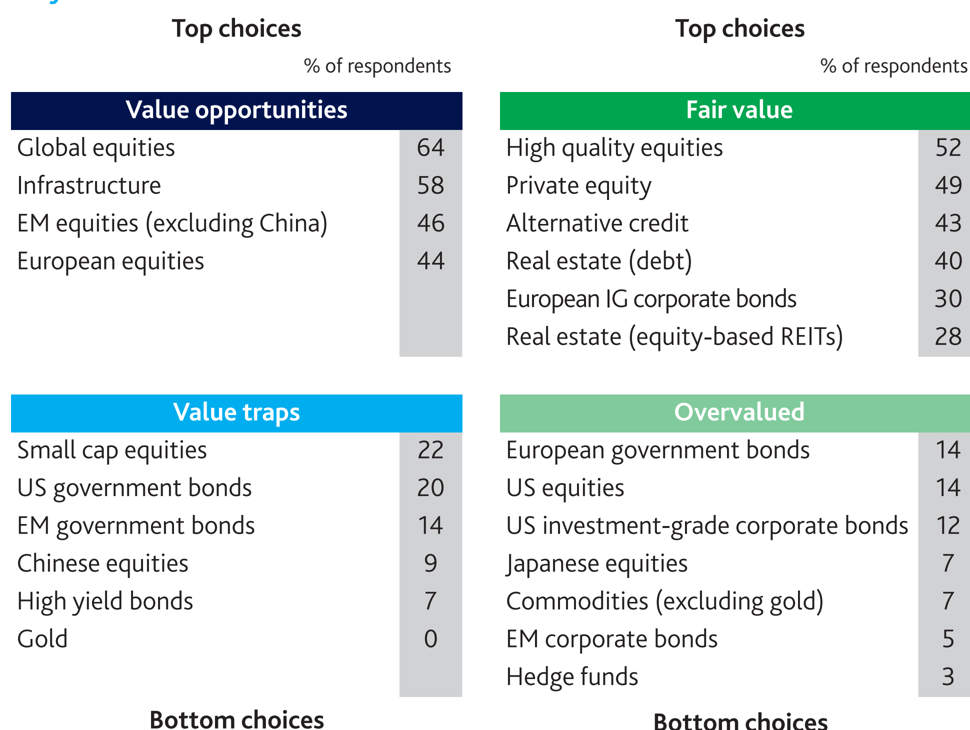
Such pragmatism will favour ten asset classes potentially offering either 'value opportunities' or 'fair value' (Figure 1.4, upper half). It will disfavour the others as exposed to 'value traps' or 'over-valued' (lower half).

Selective equities (global, European and EM) will be favoured, but not US equities, which are trading at 18 times forward earnings: well above their 10-year average. No region stands out for super returns.

Credit as an asset class is also close to over-valuation. So, the search for yield will favour illiquid assets like real estate, infrastructure and alternative credit. They hold two attractions with ageing member demographics: regular cash flow and inflation protection.

Finally, overriding this assessment is the bigger concern about how the volatility–liquidity 'doom loop' will play out, when the 35-year bull market in bonds ends.

Figure 1.4 What asset classes will be most suited to meet your pension plan's needs over the next three years?



Top choices (% of respondents)

Value opportunities	%
Global equities	64
Infrastructure	58
EM equities (excluding China)	46
European equities	44

Fair value	%
High quality equities	52
Private equity	49
Alternative credit	43
Real estate (debt)	40
European IG corporate bonds	30
Real estate (equity-based REITs)	28

Bottom choices (% of respondents)

Value traps	%
Small cap equities	22
US government bonds	20
EM government bonds	14
Chinese equities	9
High yield bonds	7
Gold	0

Overvalued	%
European government bonds	14
US equities	14
US investment-grade corporate bonds	12
Japanese equities	7
Commodities (excluding gold)	7
EM corporate bonds	5
Hedge funds	3

Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"25% of returns in a bull market come in the late stage, when optimism peaks."

"When markets turn, how liquidity and correlations will play out is anybody's guess."

Theme 5 Asset allocation is moving away from a formulaic approach

As the old ways of investing were no longer working, asset allocation approaches began to morph with innovations coming on stream.

The Lehman crisis in 2008 was a turning point. The sheer scale and speed of the resulting sell-off turned capital conservation into the top goal of pension plans. But they soon realised that over-caution carried its own risks because of a double whammy: soaring liabilities due to zero-bound interest rates and subpar returns due to price distortion by QE. Funding ratios took a hit and pushed some 40% of pension plans across Europe into negative cash flow status with ageing demographics.

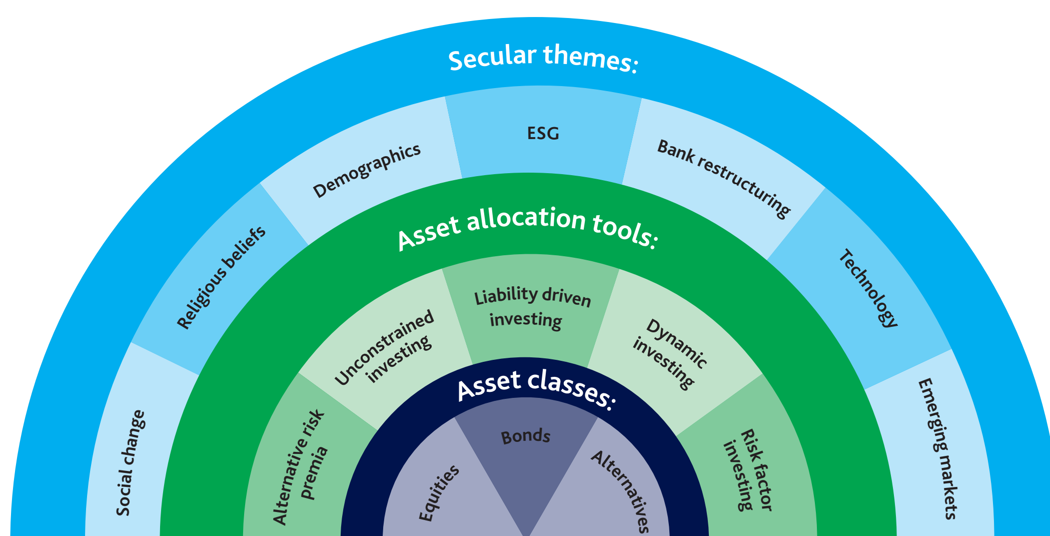
As the old ways of investing were no longer working, asset allocation approaches began to morph with innovations coming on stream. Most of them had been around before the crisis, but their adoption gained a tailwind after it. They fell into three distinct spheres (Figure 1.5). Here we focus only on their salient growth points.

The first sphere covers asset classes (innermost semi-circle). The switch to alternative investments has accelerated in this decade, especially favouring infrastructure, real estate, private equity and alternative credit. They will continue to attract rising allocations over the rest of this decade (according to 62% of our respondents), as shown in Section 3.

The second sphere covers new tools of asset allocation (second semi-circle). A number of these have been implemented. Three of them will remain hot favourites: risk factor investing (58%), uncorrelated absolute return investing to ride out risk-on/risk-off cycles (53%) and alternative risk premia to exploit temporary price anomalies (48%); as shown in Section 3.

The outer semi-circle covers secular themes that override market cycles, since they have the momentum of a supertanker. Fears of secular stagnation caused by rising global debt will continue to favour secular themes. The most successful themes of the past ten years have been technology and EM. Looking ahead, ESG will be the top theme (51%), as shown in Section 3. Delivering decent returns apart, ESG is also viewed as a risk management tool.

Figure 1.5 How is asset allocation morphing by blending asset classes, allocation tools and secular themes?



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"Our expectations of growth, inflation and returns are now being re-assessed."

"Diversification tools that were once peripheral are now going mainstream."

Theme 6 IORP II will drive out structural inefficiencies

Some pension plans want to have their own IORP. Others want to buy into a package from external service providers that includes multiple employers.

Diversity and duplication have long characterised the EU pension landscape. Pan-European employers were obliged to run separate pension entities for each jurisdiction in line with local regulations.

The long process of consolidation and simplification started with the first IORP Directive in 2003. By 31 December 2016 – the latest date for which data are available – there were 83 cross-border IORPs, involving €63 billion (1.6%) of total IORP assets across the EU. New data due out soon will likely show a substantial rise. Some multinational companies were also implementing international pension plans (IPPs) as an interim solution before the cross-border pension fund market could fully develop.

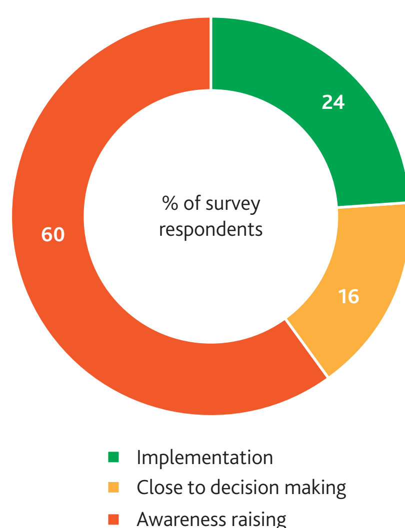
December 2017 marked an important milestone when the IORP II Directive was enacted, to be transposed onto all member states by January 2019. Currently, 24% of our respondents are already implementing it, a further 16% are close to decision-making and the remaining 60% are in the awareness-raising stage (Figure 1.6, left chart).The pace of adoption will speed up, according to 39% of our respondents, while 61% expect it to remain the same (Figure 1.6, right chart).

The latest directive sets common standards that aim to provide better protection for scheme members via harmonised rules. At this early stage, as shown in Section 3, at least one in every three respondents expects to see four benefits: a consistent reporting framework that provides better governance oversight (43%); freedom for plan members to move freely within the EU without sacrificing their pension rights (39%); economies of scale from harmonised solutions at lower cost (35%); and better asset allocation, risk management and member communication (32%).

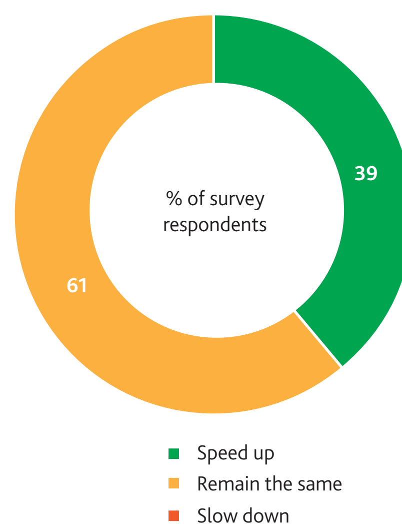
Some pension plans want to have their own IORP. Others want to buy into a package from external service providers that includes multiple employers. As benefits enjoyed by early adopters become more evident over time, the pace will accelerate in both cases.

Figure 1.6

In the adoption of the IORP II Directive, in which stage is your pension plan currently?



How will the adoption profile change over the next three years?



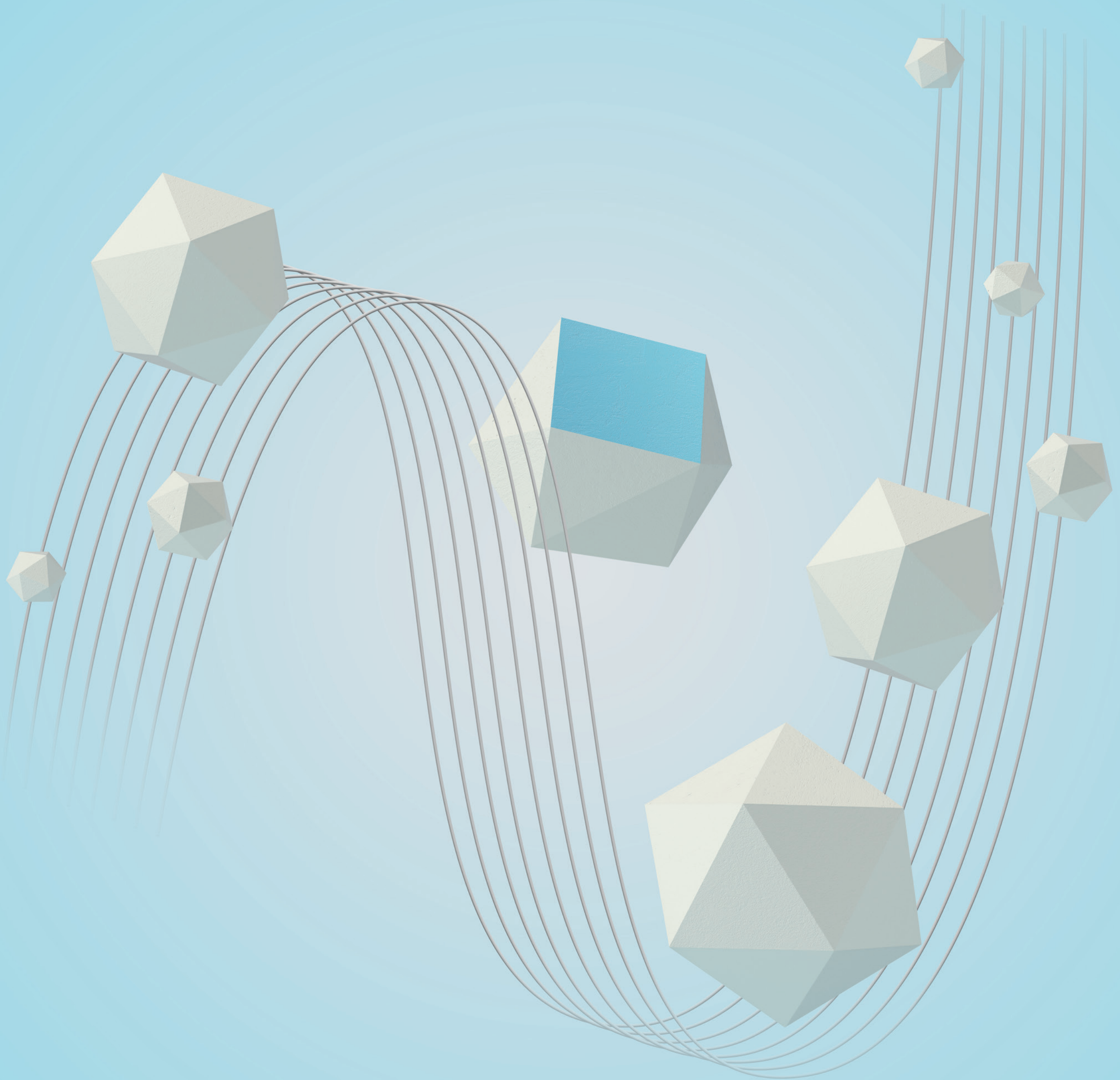
Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"We need a one-stop-shop facility that reduces complexity in our pension plans in the EU."

"Consolidation will be a long drawn-out process, given the current scale of duplication."

2 Drivers of asset allocation:
Where will the returns come from?



Headlines

- Markets will experience heightened volatility
- Investors are braced for an era of lower returns
- No region especially stands out as the best place to invest

Aims

Taking a three-year forward look, this section addresses three questions:

- what factors will drive financial markets?
- which asset classes are likely to be favoured by pension plans?
- which regions are likely to offer the best returns?

Key findings

a. Market drivers

"Asset valuations are over-stretched and markets are due for correction. It is already happening in EM and starting to happen in DM."

An interview quote

At least 2 in every 5 survey respondents have identified five interrelated drivers. In descending order of importance, they are:

- the unwinding of QE
- the rise of protectionism
- the slowdown in the global economy
- the rising level of global debt
- the return of inflation.

Under their combined effects, markets will turn more volatile.

b. Favoured asset classes

In the light of the identified drivers, at least 2 in every 5 respondents will favour five asset classes. In descending order of importance, they are:

- global equities
- infrastructure
- private equities
- high-quality equities
- EM equities (excluding China).

Valuations are decidedly in the late stage, after the longest bull market in history. QE has also borrowed against future returns. The era of low returns is already here.

c. Favoured regions

So broadly pervasive has the current bull market been that valuations are stretched in almost all the financial markets.

There are no clear regional standouts for good returns over the rest of this decade.

Five regions favoured by at least 1 in every 3 respondents include, in descending order:

- Asia (excl. China)
- United States
- India
- Western Europe (excl. the UK)
- China.

The overriding messages are:

- although the global economy will continue to recover, signs of stellar growth outside India are hard to discern, while new risks are piling up
- pension plans are enjoined to walk the fine line between caution and opportunity.

Markets will experience heightened volatility

Fears persist that the Fed may not have enough ammunition when the next recession comes; nor will it be able to act as the global lender-of-last-resort, as it did in the last crisis.

Over the past 24 months, the volatility of the MSCI World Index has averaged 8% compared with the historical norm of 15%. It is expected to revert to the mean over the next three years with periodic spikes, due to the joint effect of five key market drivers (Figure 2.1).

54% of the respondents to our survey cite the unwinding of quantitative easing as the key driver, as global growth has picked up lately. The post-crisis super-easy money policies have artificially boosted valuations of all asset classes in every region.

The US Federal Reserve plans to shrink its balance sheet by $1 trillion dollars by the end of 2019. This is equivalent to another 130 basis points of tightening, on top of two or three additional rate hikes in both 2019 and 2020. Even with this degree of tightening, fears persist that the Fed may not have enough ammunition when the next recession comes; nor will it be able to act as the global lender-of-last-resort, as it did in the last crisis.

53% cite the rise of protectionism in global trade, sparked by the US tariffs on China. The threat of a trade war has distracted markets throughout 2018 and is seen as the biggest negative fat-tail risk. Each twist in this saga is chipping away at investors' confidence, with no resolution in sight.

49% of respondents worry that the global economy has not been able to retain the momentum last seen in 2017. It will be unexceptional in all regions except India. The growth engine in the rest of the emerging markets will shift down a gear. While there are no clear signals of a recession in sight, there is consensus that the global economy is in the late stage of the current cycle.

44% worry about the rising level of global debt from 225% of world GDP in 2008 to 330% in 2017; a year in which 37% of global companies were highly indebted, according to S&P, the credit rating agency. Debt will weigh on future growth by depressing future consumption.

Figure 2.1 Which factors will drive financial markets over the next 3 years?

Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"There's no fuel left in this bull market. There are no new booster rockets on the horizon."

"Economic growth will be lower in all regions, mainly due to the tariff disputes."

Credit quality overall has been deteriorating worldwide. In America, for example, 48% of investment grade bonds are now rated BBB, up from 25% in 1990. The rise has been sustainable while profits have been rising and rates have been zero-bound. As either or both of these are removed, many companies may go under.

Credit quality overall has been deteriorating worldwide.

40% fear the return of inflation. Central banks doubt whether the Philips curve will continue to remain dormant. With populist policies in the ascendancy, wages are expected to grow faster than GDP. Additionally, if the current tit-for-tat tariffs escalate, costs will rise in global supply chains. But central banks remain less allergic to inflation than they once were. They are tacitly moving towards symmetric inflation targets; allowing overshoot in both directions, rather than setting hard targets.

Hence, there are a number of unfamiliar risks looming on the horizon. Yet, equity markets in the West appeared to be defying gravity until recently, while many EM equities are already in bear territory. It is uncertain whether this divergence reflects a cyclical sugar high from fiscal expansion on both sides of the Atlantic; or the start of a supply-side renaissance, shifting the centre of gravity in the manufacturing sector to the West driven by the current digital revolution.

In the meantime, pension plans have to perform a delicate balancing act. On the one side, recognising that future returns for most asset classes will be much lower, as QE has already brought them forward; and on the other side, avoiding the regret of missing a once-in-a-generation market rally.

After all, history shows that, in a prolonged bull market, 25% of returns come in the late stage, when the fear of losing out overshadows any anxiety about the impending crash.

Unsurprisingly, most of our respondents are being pragmatic, blending caution with opportunity (see Insights).

Interview quotes

"How viable is an economic recovery based on an unprecedented amount of global debt?"

"Missing the late stage of a raging bull market may mean losing 25% of the gains."

Insights

Value versus momentum: not either/or, but both

The market recovery since 2009 has delivered exceptional returns despite tepid economic growth. Unconventional central bank action has lifted all asset classes and disconnected their market prices from their fundamentals. As central banks effectively set a floor below which asset prices could not fall, passive investing has taken off and active funds have struggled to beat their benchmarks. The current bull market looks like a gigantic momentum trade.

We have, as a result, doubled our exposure to passive funds. The decision was also influenced by historical data on equity returns. First, 70% of the time, markets are in a bull phase. That explains why the long-term trend in equity returns has been upwards, with cyclical downturns periodically. Second, 70% of our returns come from market betas. It means you have to ride the momentum bandwagon when it is rolling.

It may well continue to do so, if there is pressure on the Fed to keep the party going. After all, President Trump has often cited the stellar 23% rise in the MSCI World Index in 2017 as the best evidence of the success of his policies.

Yet, it is hard to overlook the fact that value stocks, long shunned by the markets, could be coming back into favour, as fears grow over trade disputes, higher inflation and monetary policy unwinding. This is already evident in the latest reading of the Russell index of 1,000 companies. For the first time since March 2018, value stocks are outperforming growth stocks by a wide margin. Recent academic studies also show that value factor is not dead.

Investors typically rush into value stocks in the later stages of an economic cycle, before a recession. But current valuation metrics are no longer good at predicting when the factor reward will materialise. For now, we are backing both the value and the momentum horses. For example, longer term data since 1900 shows that missing the 10 best quarters could mean losing more than 90% of the gain on UK equities. Also, missing the two worst quarters of returns would almost double the cumulative real gains on UK stocks.

~ A French pension plan

Investors are braced for an era of lower returns

History shows that when real interest rates are abnormally low – as they are now – future returns on equities and bonds tend to be lower.

Investors are facing challenges that go beyond the realm of a maturing business cycle, as the age-old global trade and security order is being up-ended.

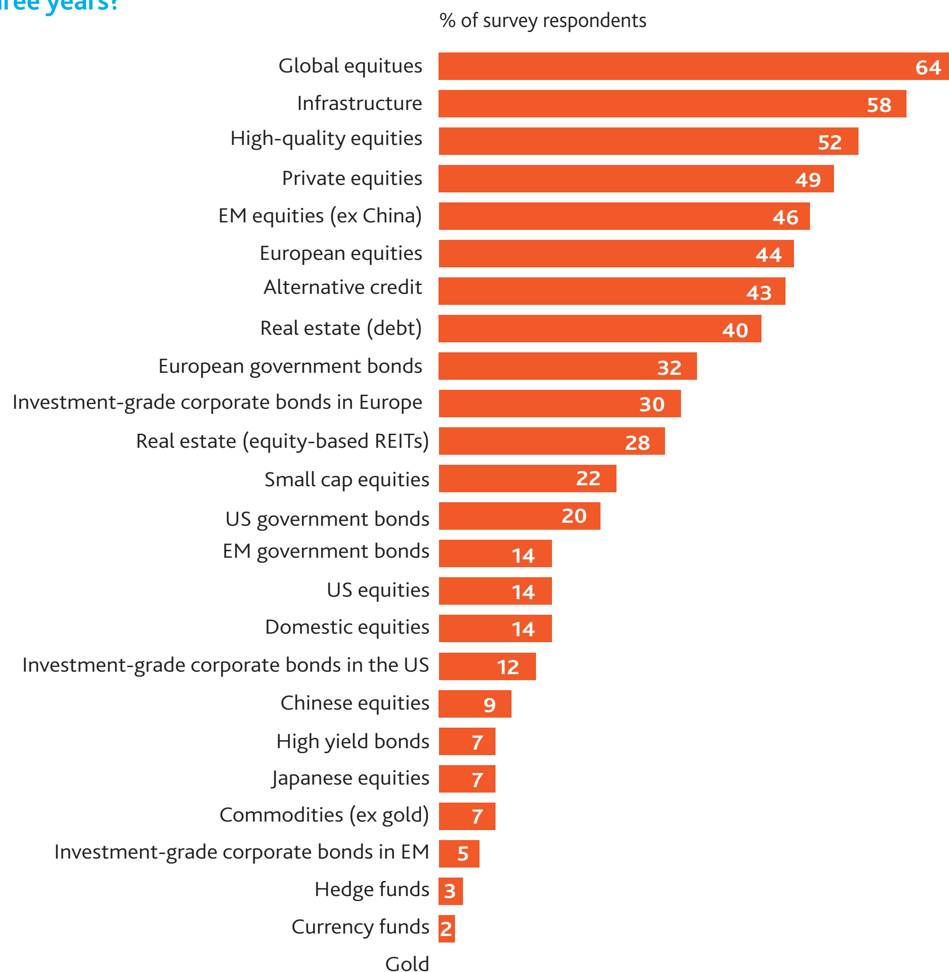
History shows that when real interest rates are abnormally low – as they are now – future returns on equities and bonds tend to be lower, in marked contrast to the current situation in all the key economies. Hence, hitherto off-market buyers like central banks and Chinese investors – riding a liquidity wave in their country – are pulling back, thus reducing market depth.

In this environment, our survey has identified the asset classes they are likely to favour (Figure 2.2). Our post-survey interviews then sought to classify them into four groups, as shown in Figure 1.4 in the *Executive Summary*. The overriding message from the interviews is that investing will remain a relative value game in a low-return environment. Five other salient points also emerged.

First, certain categories of equities will remain popular, while others may not. The popular ones include global equity (cited by 64%), high-quality equities (52%), EM equities (excluding China) (46%) and European equities (44%).

US equities are conspicuously absent in this list and their current weighting is unlikely to rise (14%). Their overstretched valuations are already showing signs of correction. The S&P

Figure 2.2 Which asset classes will be most suited to meet your pension plan's goals over the next three years?



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"The US equity market remains a bull among bears. But for how long?"

"Infrastructure has generated 5% annually (in dollars) over the past three years for us."

Liquidity vanishes when it is most needed, causing a mass exodus of investors, a sharp decline in prices and outsized losses for sellers.

500 now trades at 18 times forward earnings – well above its 10-year average. The Shanghai Composite, in contrast, trades at 10.2 times and the Stoxx 600 fetches 14.5 times. In Europe, well-governed companies offer investors the opportunity to generate growth in the years ahead, in sectors like industrials, technology and consumer staples.

Second, EM equities and debt offer the best return prospects on a time horizon of five years or more. In the short term, however, they are too vulnerable to US rate hikes and trade disputes.

Third, credit as an asset class is also close to overvaluation. Last summer, the credit rating agency Moody's reported that its loan quality indicator fell to its worst recorded level in the first quarter of 2018, indicating that collateral may not be available in the bankruptcy scenario. Sovereigns, too, are seen as overvalued.

Fourth, in search of yield, inflows into real estate will be increasingly targeted at value-added investments, with a higher risk–return profile than core investments, which are already over-valued. The preference for opportunistic investments, the top end of the risk–return spectrum, is also set to rise.

Fifth, as they move into negative cash flow status with ageing membership, pension plans are expected to continue favouring real assets, with strong cash flow features (see Insights). Infrastructure, real estate and alternative credit will feature high on their list.

Overriding this assessment is a wider concern: what will happen as the 35-year bull market in bonds comes to an end? Recent episodes show that when liquidity is reduced, bid-ask spreads tend to widen disproportionately, making it harder to exit positions when volatility spikes, as happened in February 2018.

That episode yet again confirmed the age-old paradox: liquidity vanishes when it is most needed, causing a mass exodus of investors, a sharp decline in prices and outsized losses for sellers. As the 35-year bull market in bonds shows every sign of ending, how this negative feedback loop between volatility and liquidity will play out during periods of market stress ahead remains a serious concern.

Interview quotes

"Nobody under the age of 60 has the experience of a bear market in bonds."

"Most of the value of equity investing is now realised via either private markets or early-stage seed finance, not public markets."

Insights

The rise and rise of cash flow-driven investing

Last year, 55% of DB plans in the UK were cash flow negative. We have already been in that challenging situation since 2015. It exposes us to the risk of being a forced seller in a down market, when asset disposals become the only way of paying pensions to our members.

As a preventive measure, over the past five years, we have been rebalancing our portfolio towards three asset classes with regular and predictable cash flows, while enjoying a handsome illiquidity premium of up to 2% annually: real estate, private debt and infrastructure.

They have three common merits. They are good diversifiers: they have a very low correlation with traditional equities and bonds, except in a severe crisis like the one in 2008. They are also regular cash flow generators. They enable us to pay out pensions irrespective of the wider environment. Finally, they are backed by solid collaterals: and unlike equities, their valuations do not fluctuate much from year to year. Beyond that, each of these also has some unique positive features.

The pension plan run by our Danish subsidiary comes under Solvency II rules. For it, infrastructure carries a low capital charge compared with investment grade bonds.

With real estate, our investments are less exposed to the adverse impact of interest rate rises on property valuations. There is also a good capital upside as property prices and rents tend to rise with general inflation.

With private debt, our investments are insulated against rate rises due to their floating rate structure. The default rate has been around 2% and delivers CPI+5%.

We see enormous potential for infrastructure investments globally. The only inhibitor currently is political risk, such as nationalisation or new regulation. Public authorities are always tempted to move the goalposts in their favour.

~ A UK pension plan

No region stands out as the best place to invest

In the light of the market drivers identified previously, it is unsurprising that our survey respondents were unable to single out regions with overwhelming advantages for investors. At least 1 in every 3 respondents gave roughly equally low weighting to five regions that were likely to deliver the best relative returns over the next three years. In rank order, they are: Asia excluding China (cited by 40%), the US (38%), India (37%), Western Europe excluding the UK (35%) and China (33%).

Wall Street's stellar spell shows every sign of being over, with rising 10-year yields and jittery markets.

The upshot is that the low return environment is likely to be a global phenomenon. There are some general and some specific observations that underpin this assessment.

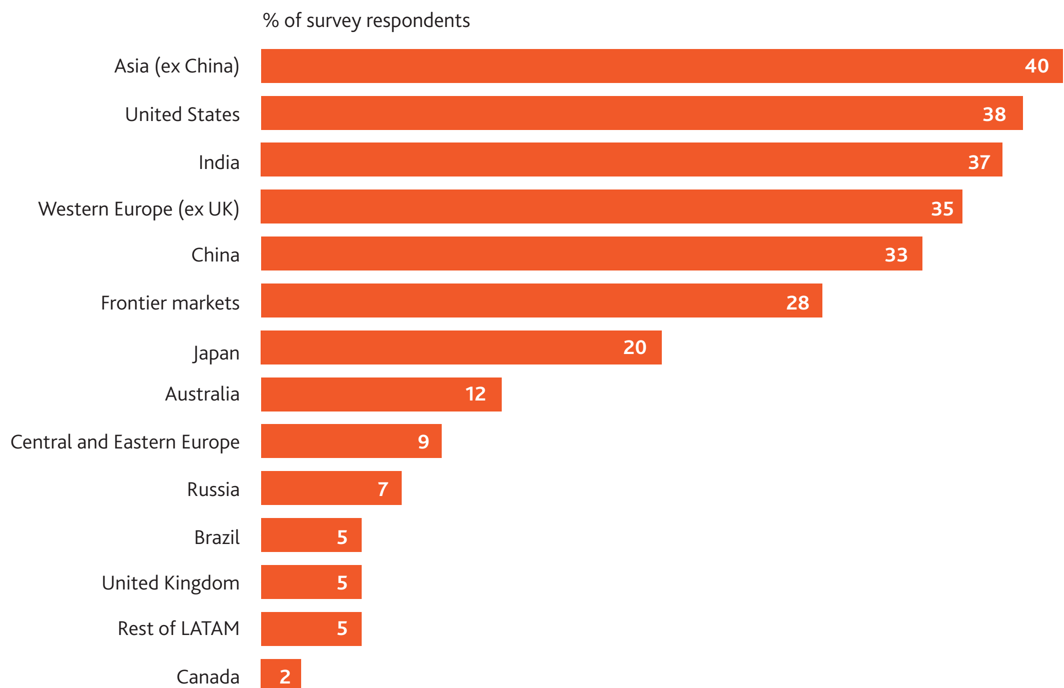
On the general side, the escalating trade war between the US and China could be hugely consequential for many other regions, given their financial linkages, intricate supply chains, and high export dependency. As US rates rise and the dollar appreciates, US exporters also face a double whammy: lower exports and lower foreign earnings. Wall Street's stellar spell shows every sign of being over, with rising 10-year yields and jittery markets.

For the $20 trillion US economy, tariffs are seemingly not a big deal. But if the trade dispute escalates, the harm from the loss of investor confidence may be considerable. After all, one third of the $15 trillion in outstanding US treasury bonds are held by foreign governments. A third of the stock market is also owned by foreign investors.

Another general point refers to views about emerging markets. In the 1990s, investors underestimated their weaknesses before the 1994 'Tequila' crisis in Mexico sparked a market contagion in Asia.

In the last decade, in contrast, investors overestimated the strengths of EM. The 2013 'taper tantrum' showed how the fortunes of EM are still so inextricably tied to the US dollar. Investors are now demanding higher risk premia as a result. They also want to see reforms of restrictive labour practices, opaque governance practices and protectionist trade policies – to improve their resilience to external shocks.

Figure 2.3 Which regions are likely to offer the best returns over the next three years?



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"If you didn't own FANG stocks in the S&P 500, your performance would have been mediocre."

"The relative valuation of EM equities versus broader global equities remains attractive."

Indian equities appear to have factored in all the good news in the pipeline.

This applies especially to China, now caught in the cross hairs of a trade dispute (see Insights).

Moving to specific points, India's fundamentals remain solid despite the falling rupee. It is uniquely poised to deliver stellar annual growth of around 7.5% over the rest of this decade. Two reforms of the past two years – demonetisation of all transactions and a new goods and services tax – are paving the way for other reforms in areas like bankruptcy code and infrastructure investment. However, the recent large wave of defaults in the shadow banking sector, with huge infrastructure lending, yet again highlights the problems in the nation's banking sector. These are now weighing on equity markets, which appear to have already factored in all the good news in the pipeline.

Another specific point applies to Europe. Despite the rise of populism in a number of countries, the euro remains broadly popular. However, diversity in economic conditions and inflation among countries in the eurozone has complicated the task of the European Central Bank. It is expected to remain dovish, until growth is on a better footing. Without structural reforms, economic growth will remain heavily dependent on ECB policy. In the meantime, private companies – offering exciting opportunities in Europe – will continue coming to the market via IPOs. Also, Europe's valuation will remain less distorted: its share of passive funds is lower than that of the US.

In the UK, the economy will remain sluggish and fragile due to reduced immigration, weak productivity growth and fiscal austerity. Its secular outlook hinges on the resolution of Brexit. After two years of Brexit uncertainty, the pound has dropped 12%. The economy is already 2.5% smaller than it would have been otherwise. The currency will remain on a downward trajectory while politicians debate if, when and how to leave the EU.

Interview quotes

"Without improved corporate governance in EM, we always demand high risk premia."

"There are many pockets of value opportunities in Europe, including IPOs."

Insights

Promise and peril in China

Since the market trough in 2009, the S&P 500 has gained 320%, Japan's Nikkei 225 has gained over 200%, while Hong Kong's Hang Seng has gained nearly 150%. But mainland China's Shanghai Composite is only up 27%.

The divergence has intensified lately, as the tariff dispute has escalated. The plain fact is that China has a lot going for it and a lot going against it. It is caught in a warped transition, as its growth slows down. However, it still remains a big swing factor in global growth.

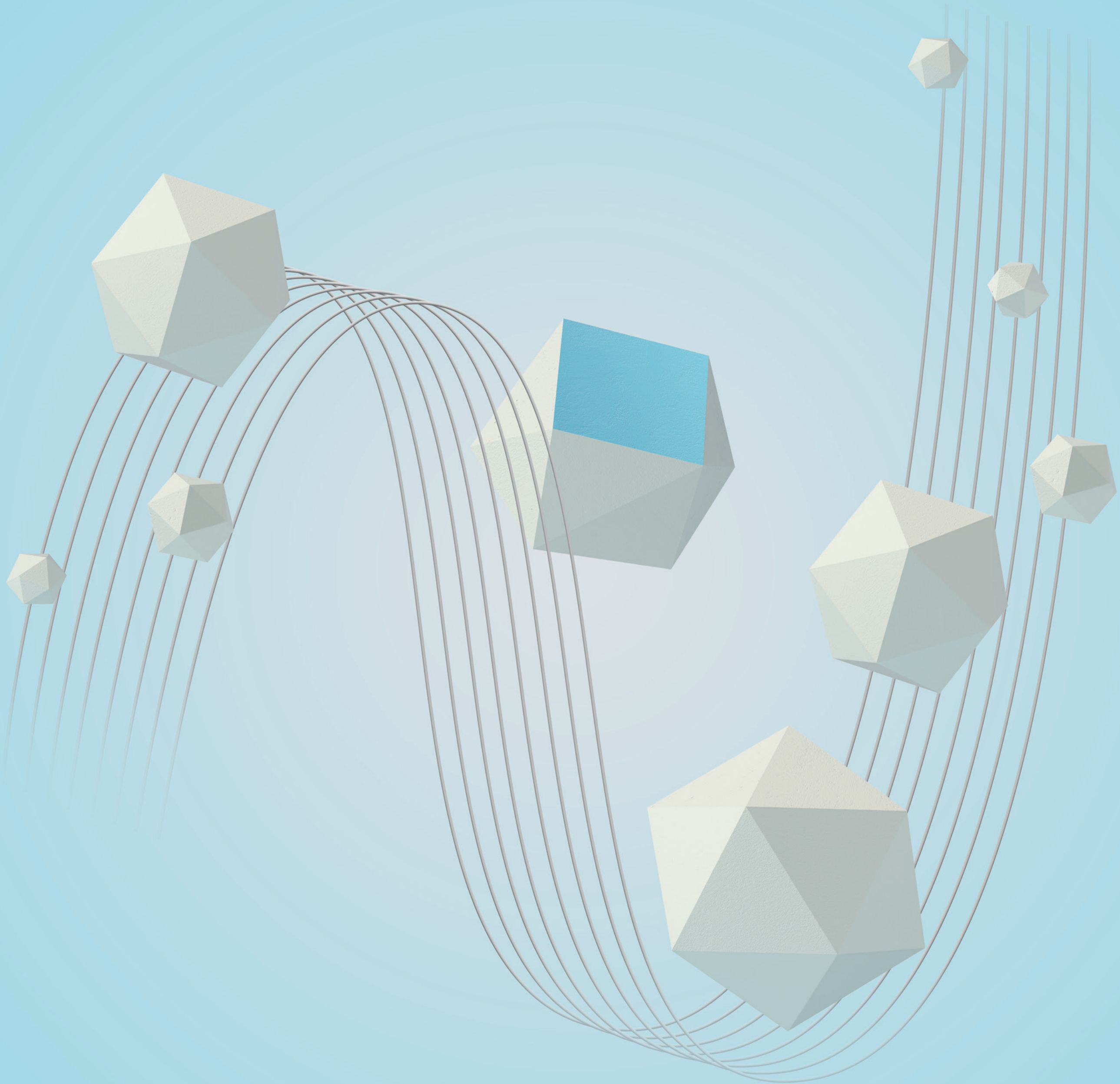
Its One Belt, One Road initiative – on new roads and maritime links – could potentially be transformational for the economies of Asia and Europe. In financial resources, it is expected to be 12 times bigger than the US-sponsored Marshall Plan that revitalised Europe's economies after the last War. In addition, China is now the world's largest e-commerce market and accounts for more than 40% of e-commerce transactions, up from less than 1% a decade ago. It is also now reforming its 'shadow banking' sector, estimated to comprise up to 50% of all loans in China and its unsustainable credit explosion.

On the downside, China has attracted criticism from many WTO members for its hidden subsidies, lack of a level playing field between state-owned enterprises and private companies, infringement of intellectual property rights and currency manipulation. China's rise as an economic superpower has largely happened under unfair practices that contravened international rules. Long-awaited liberalisation reforms on the role of markets and capital accounts are slow and patchy, while policy attention is focused on avoiding a credit crunch. America's imposition of tariffs on $250 billion of Chinese imports is not altogether surprising, although the manner of its implementation is debatable. The inclusion of the A-shares in the MSCI EM Index is a great opportunity to tackle the issues that have long hurt equity prices in China.

We are underweight on China. First, the high volatility of Chinese A-shares presents problems for our plan sponsor as it is reflected in its financial statement directly and share prices indirectly. Second, governance structures and transparency practices of many enterprises contravene our long-held standards. Finally, we worry that the current China–US tariff dispute could spin out of control.

~ A German pension plan

3 New approaches for a new era:
How is asset allocation exploring new frontiers?



Headlines

- Asset allocation is morphing into new forms
- Sustainability does not mean sacrificing performance
- IORP II can potentially transform the EU pension landscape

Aims

Taking a three-year forward look, this section addresses three questions:

- how are asset allocation approaches changing in this era of low returns and high volatility?
- what role does ESG play in the changing approaches?
- what will be the impact of IORP II on the economics of pension plans?

Key findings

a. Asset allocation

"ESG is gradually becoming the gold standard of investing as markets are pricing in climate change risks."

An interview quote

It is evolving in different directions: some inter-connected, others distinct. In descending order of importance, the evolution is embracing:

- real assets
- uncorrelated returns
- secular themes
- longer time horizons
- alternative risk premia
- buying the dips
- smart beta.

b. ESG

The UN's blueprint on *Sustainable Development Goals* is being treated as a key secular theme with good return potential. It is being implemented via:

- exclusionary screens
- overt inclusion of ESG criteria into the investment process
- specific targets on environmental and social goals on top of the financial ones.

In order of importance, governance is accorded higher priority than environment and social, because it is viewed as setting the basis of environmental and social standards.

c. IORP II

This EU directive, too, will make new demands on governance and investment side. But in return, it will deliver some tangibles. In descending order, they are:

- better governance oversight
- better labour mobility of workers across the EU without sacrificing their pension rights
- economies of scale from streamlined activities and resource pooling
- better asset allocation, risk evaluation and member communication.

Asset allocation is morphing into new forms

Real assets are also seen as surrogate assets for sovereign bonds in the LDI glide paths.

As pension investors enter the low return/ high volatility era, it is widely believed that the traditional 60:40 equity–bond portfolio will not meet return targets. So, new approaches are now being implemented to augment it via new tilts (Figure 3.1). At least 2 in every 5 respondents are implementing one or more of seven changes: some complementary, others distinct.

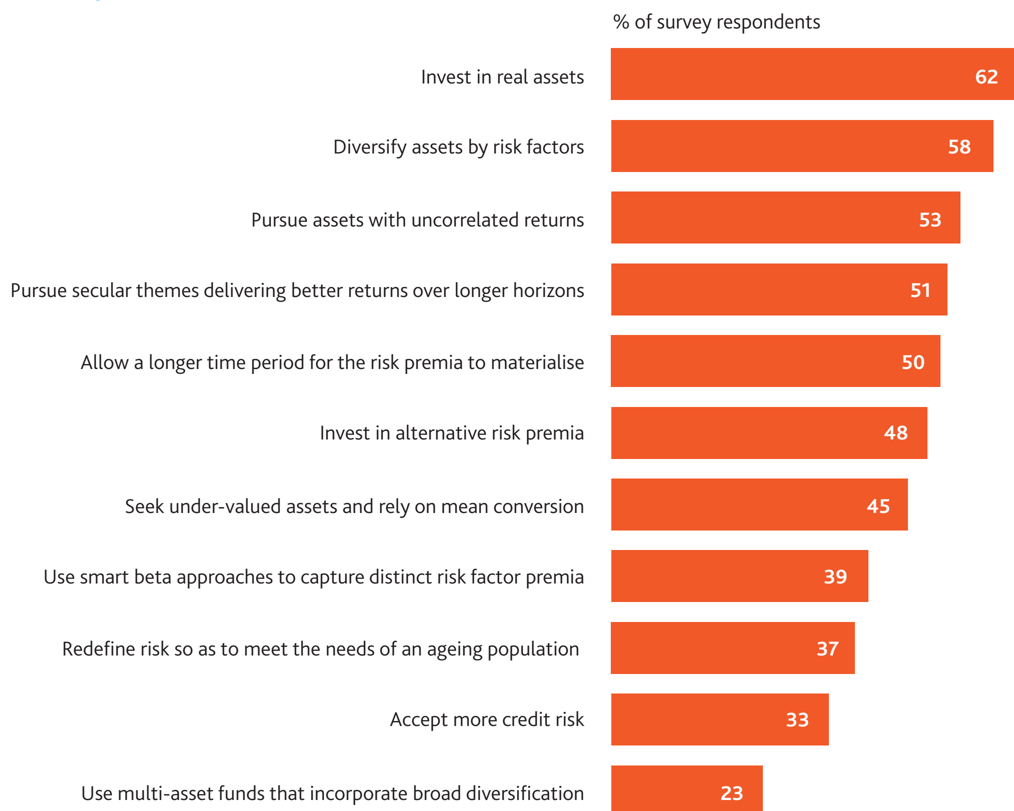
62% are investing more in real assets, comprising mostly real estate and infrastructure. Their illiquidity premium of around 2% apart, these assets are favoured for their regular cash flow and inflation protection. Real assets are also seen as surrogates for sovereign bonds in the LDI glide paths, as the global pool of AAA-rated bonds has contracted by 70% since 2011, with sovereign downgrades of various countries, including the US and the UK. Besides, QE has overinflated the price of sovereign bonds (see Insights next page).

58% are adopting risk factor investing. In the past, diversification was based on asset classes, without regard to the fact that seemingly different asset classes can have unusually high correlations due to their common exposures to underlying risk factors. Assets are now increasingly allocated by their risk.

53% are pursuing uncorrelated returns to ride out the future risk-on/risk-off cycles. In the past, the resulting unusual volatility in equities has impacted on the share prices of plan sponsors indirectly under the mark-to-market rules. This will favour alternative investments, especially real assets and private equity.

51% are pursuing secular themes – especially ESG – that override market cycles due to their structural momentum. Other secular themes, like EM and technology, have delivered stellar returns in the past 10 years.

Figure 3.1 **Which of the following actions are being taken by your pension plan to cope with the high-volatility/low-return era?**



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"The old style diversification is not suitable in a period of high volatility and low returns."

"By using our balance sheet, we are supporting local infrastructure projects."

The old-style 60:40 approach is too formulaic for value creation in the new environment.

50% are extending their time horizons to capture risk premia, especially for value investing that relies on mean reversion.

48% are adopting alternative risk premia in the belief that there are plenty of short-term price anomalies due to investors' well-known behavioural biases, which offer good opportunities. They are often overlooked by the buy-and-hold style that avoids shorting, leverage and derivatives (Insights below). Price anomalies will increase with rising volatility.

45% are seeking under-valued assets and rely on mean reversion to work in order to realise the intrinsic value of the asset.

39% are using the smart beta approach to harvest different risk premia at different stages of the market cycle. The idea that factor premia exist and have a long pedigree is now widely accepted.

These and other approaches in Figure 3.1 underscore two points.

First, the old-style 60:40 approach is too formulaic for value creation in the new environment. Instead, it favours a blended approach, combining caution and pragmatism; cyclical and secular themes; as well as short-term opportunism and medium value creation.

Second, markets will remain distorted and jittery, as central banks unwind their super-easy money policies. The sheer scale of global debt will continue to cast a shadow over their normalisation. It will be fraught with mis-steps and mis-timings, if the past is any guide.

Interview quotes

"There is long-term evidence, spanning many countries, that factor premiums exist."

"Shares of companies that markets overlook are coming back as markets peak."

Insights

Seeking alternative risk premia in a low-return era

For us, the 2008 crisis was a turning point. Traditional diversification failed when it was most needed. Since then, conventional investment wisdom has been sidelined by negative real yield and high volatility. For us, being risk averse became the biggest risk. So we needed changes.

At the start of this decade, our assets fell into two distinct buckets. One targeted high returns by covering equities, high yield, hedge funds and investment grade credit. The other aimed to hedge our risk via sovereign bonds.

As the decade progressed, however, neither bucket met our expectations. Equities became very volatile during 2011-14. Under mark-to-market rules, this indirectly affected the share prices of our plan sponsor. In addition, there was a 70% contraction in the global pool of AAA-rated bonds. As a result, we took two sets of actions.

We rebalanced our portfolios in favour of assets that have bond-type features and equity-like returns. They involved real assets – infrastructure, wind farms and real estate – to augment our hedging portfolio. They also included private debt, to beef up our return-seeking portfolio.

Lately, we have started investing in alternative risk premia in order to meet our return target of CPI+3%. It rests on the belief that alternative premia exist because of investors' behavioural biases that make them do things contrary to their best interests, like buy-high/sell-low. We aim to harvest risk premia that are uncorrelated with major markets, using a rules-based systematic strategy that minimises such biases on our part. Simulations have shown that a traditional 60:40 equity–bond portfolio was unlikely to help meet our return target on a ten-year view.

Our ARP strategy covers three factors: 'value', which targets under-priced assets; 'momentum', which targets assets whose prices have been rising recently and selling assets whose prices have been falling; and 'carry', which takes a long position in higher-yielding assets financed by a short position in low-yielding assets. Our previous long-only portfolio did not exploit short-term price anomalies in a way that shorting now allows us to do.

Our initial results are in line with expectation and we expect to increase allocations as the new era of volatility throws up value opportunities.

~ A Danish pension plan

Sustainability does not mean sacrificing performance

Launched in 2006, the UN-backed *Principles of Responsible Investing* are now supported by nearly 1900 asset owners, asset managers and their service providers worldwide. At the 2015 COP21 Paris conference, 195 countries committed to reduce carbon emissions to achieve the 2° Celsius scenario. In the same year, the UN also issued a new implementation framework for its 17 *Sustainable Development Goals* aimed at bolstering infrastructure spending, ending poverty and making the planet greener.

ESG is pivoting towards mainstream. No longer a box-ticking exercise, it is a hard-nosed approach to investing as unfamiliar risks emerge.

Pension plans are now adopting a holistic investment process where ESG factors sit beside financial factors, such that assets are managed from a total risk–return perspective. ESG is pivoting towards mainstream. No longer a box-ticking exercise, it is a hard-nosed response to the rise of unfamiliar risks. The pace is faster in equities than bonds (see Insights next page).

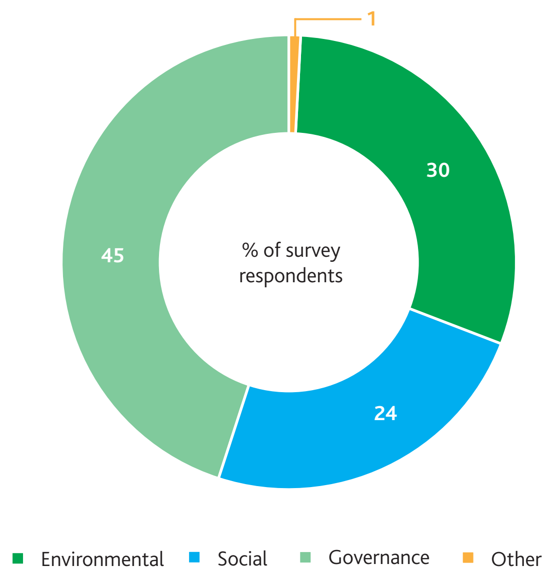
Such ESG integration is now occurring in three ways: using exclusionary screens to remove companies or industries not aligned to investors' ethical goals; evaluating all companies along ESG measures; and targeting specific social or environmental goals on top of financial returns. All this is done in the belief that ESG not only delivers better-informed decisions and credible outcomes. It also acts as an early-warning system for fat-tail or far-off risks that are hard to model statistically, owing to their long-term and infrequent nature.

Finally, taking an activist stance on governance – by exercising voting rights and strategic engagement – can deliver long-term value while exercising responsibility as an asset owner. Worldwide, some $20 trillion are now invested based on ESG criteria.

When asked to rank the individual components of ESG in terms of their importance to pension investors, 45% identified 'governance', 30% identified 'environment' and 24% identified 'social'. However, the three are viewed as mutually reinforcing, not exclusive.

The starting point for ESG investing is governance. It forms the basis of strong environmental and social standards. It plays a key role in understanding how the company's vision and business practices are aligned to delivering the sustainability goals. Critical

Figure 3.2 **When considering ESG investment for the longer term, which component do you consider to be the most important?**



Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"Simply excluding the so-called sin stocks is not enough to deliver good returns."

"ESG is de facto becoming a gold standard of investing as markets are pricing-in distant risks."

Statistical models show that stocks in the worst ESG quintiles have total volatility that is higher by 10-15% and the betas that are higher by 3%.

to all three is investment stewardship that promotes active engagement with companies to protect and enhance the value of their shareholders' assets. Ethical exclusions without engagement have not delivered good returns for many pension plans.

As yet, there are no performance data going back far enough to confirm if ESG is a factor that drives risk and return in a systematic way over a long period – like traditional factors, such as value, momentum and low variance.

But ESG exposures are still deemed to be conveying information about future risks that are not captured by statistical models. The case in point is the current large reserves of fossil fuels. These could turn into 'stranded assets', as the global economy transitions towards a low-carbon future.

Opinion and evidence differ over whether ESG adds value. For most investors, it is a relatively new phenomenon. Only over time will its impact become more evident. But its role as a risk mitigation tool is clear. Statistical models show that stocks in the worst ESG quintiles have total volatility that is higher by 10-15% and betas that are higher by 3%.

In the near term, one key challenge is the paucity and reliability of ESG data. They emanate from a diversity of sources and do not follow uniform definition and data collection practices. Data vendors use different definitions that don't – as yet – fit into a standardised format. Evidently, there is over-reliance on self-reported data, which encourages companies to report favourable data or opt out completely.

That does not detract from an important recent development. Large pension plans are already benchmarking their equity investments against a global equities index that selects best-in-class companies that are solving ESG issues.

Interview quotes

"Corporate bond portfolios of companies with higher ESG ratings tend to have better risk-adjusted returns."

"85% of millennials are either interested in, or are actually doing, ESG investing."

Insights

Green bonds: an awakening giant

So far, most of the research has focused on the relationship between ESG and equities. That is now extending into credit markets and bond markets. The UN estimates that an annual financing of around $3-5 trillion will be needed to meet its sustainable development goals.

The bulk of this money will have to come from the private sector. This has turned the spotlight on green bonds.

As part of reducing our carbon footprints under the Dutch Sustainable Development Goals, we have started making allocations to green bonds issued in Belgium, France, Germany and the Netherlands.

Equity markets have started to become a solution to the climate change problem. But bond markets are way behind in delivering the targeted financing. Their growth has been exponential but not enough. From a base of nearly zero in 2010, the global issuance is set to top €225 billion in 2018.

Their benefits are obvious: they support projects that target environmental benefits on top of other sustainability goals. At a practical level, however, green bonds are not without challenges.

They offer low yields and spreads within a wider credit portfolio, since the issuance comes mainly from government-sponsored entities with strong collaterals. Furthermore, there is no widely agreed definition of green bonds. This causes confusion among our plan trustees. Finally, our trustees prefer investments that are tried and tested by time and events. Green bonds lack the track record that can raise their comfort level.

On the flipside, our green bond investments have been able to pursue an overt green agenda – especially on carbon reduction – by mimicking the risk profile of a global corporate bond index. Given the scale of investment needed in upgrading infrastructure in America, Europe and Asia, green bonds have a great long-term future. But before then, they will suffer the usual birth pangs.

~ A Dutch pension plan

IORP II can potentially transform the EU pension landscape

IORP II will make new demands on the governance and investment side. In return, it will aim to streamline the existing arrangement which is sub-optimal.

Across the EU, there is one common trend: mergers of smaller pension plans into large consolidated units, as exemplified by the Dutch case. Over the past 20 years, the number of Dutch plans has shrunk by 75%. Similar trends are just emerging in the UK in the local government sector.

There and elsewhere, three factors have been driving the trend towards consolidation within individual member states in the EU. The main driver is the need to avoid cost duplication of common functions like ALM studies, manager selection and back office administration. In addition, as investing has become more complex over time, the need to attract the brightest and best talent has intensified. Finally, most pension plans lack the skills and governance to enter risky asset classes or reduce the principal-agency risk, which is ever present.

As we saw in Theme 6 in the *Executive Summary*, this process of consolidation is now extending – from within an individual member state to between member states. The key driver is IORP II.

It enables pan-European companies operating in multiple pension jurisdictions in the EU to have common standards across the pension value chain in key areas like governance, asset allocation, risk management and member communication. When asked to identify the perceived benefits of IORP II, at least 1 in every 3 survey respondents identified four benefits (Figure 3.3):

43% cite a consistent reporting framework that provides better governance and oversight.

39% cite freedom for employees to move within the EU without affecting their pension rights.

35% cite economies of scale from a customised solution at lower costs.

32% cite better asset allocation, risk evaluation and member communication.

In sum, IORP II will make new demands on the governance and investment side. In return, it will aim to streamline the existing arrangement, which is widely regarded as suboptimal. In this respect, our post-survey interviews highlighted four points.

Figure 3.3 What do you see as the key benefits of IORP II?

Source: Amundi Asset Management/CREATE-Research Survey 2018

Interview quotes

"Legacy pension arrangements have proved wasteful in trans-European companies."

"Most of our national plans are autonomous and have little sharing of ideas and best practices across countries."

Cost duplication cuts into investment returns.

First, the current pension arrangement in the EU is a product of history as much as geography. It is deeply entrenched in national regulations and cultures. Creating a harmonised framework, as IORP II aims to do, will take time and persistence (see Insights).

Second, as a result, progress will be incremental and focus on new pension arrangements as well as the current ones that lend themselves readily to simplification. Already, pan-European companies are showing interest in multi-employer vehicles run by external asset managers for one simple reason: it is easier to funnel new money (or marginal plans) into a new scheme run by an external provider who can deliver economies of scale at the outset, having already got the critical mass of assets.

Third, whether companies have their own IORP or use a multi-employer pooled vehicle, there is widespread concern about the extent of 'implementation leakage' from the existing arrangement that is both costly and inefficient due to its fragmented nature. Cost duplication cuts into investment returns. The need to have deep investment capabilities in this era of low returns has become critical; as has the role of first-rate risk management capabilities and sound governance. At a time when two-thirds of DB plans across Europe have funding levels below 100%, sponsors are looking for decent investment returns that can bridge the gap. Even in DC plans, members' cash balances are decidedly on the low side and not enough to deliver decent retirement outcomes.

Fourth, costs make a difference to net performance, when compounded over time. Plan sponsors are keen to have streamlined operations that deliver value for money while honouring their pension promise.

Interview quotes

"Cost savings might be obvious but the key benefit will be in the area of investment."

"IORP II will ensure that 2 + 2 = 5 by allowing the harmonisation of pension plans in the EU."

Insights

IORP II kick-starts long overdue consolidation

Our plan sponsor is a global company with over 250,000 employees, operating in all the key pension markets. Our size has resulted entirely from cross-border acquisitions, creating a mosaic of over 2,500 pension plans of extreme diversity and complexity. Alongside large DB plans in Germany, the UK and the US, we have DC plans, health insurance plans and termination plans in over 13 countries.

Even within DB plans, there is no uniformity. Some are based on final salary, some on average lifetime salary, and some on cash balances where employers do not bear the longevity risk. Some offer full inflation protection, some offer partial protection and some offer none. Some are open to new members; others are closed. Some are open to future accruals for existing members; others are closed. Some have adopted de-risking solutions; others have not. Some have in-house investment capability; others outsource it to external managers.

In summary, there is far more that divides our pension plans than unites them. Each plan has responsibility for every activity in its value chain: asset allocation, manager selection, risk management, administration and member communication. The resulting duplication is very significant and widespread.

With IORP II, however, we aim to start consolidating across the EU, once the directive is transposed into national laws in 2019. It offers scope for bringing together so many different activities under one roof and doing away with duplications that cost a lot of time and money; not to speak of missed investment opportunities from suboptimal capabilities in various jurisdictions.

Initially, the harmonisation will target low-hanging fruit like administration and member communication. But our main goal is to create a strong investment engine with high-class capabilities in three top value-added activities: asset allocation, manager selection and risk management. We have not been able to leverage our size and reach because of regulatory barriers. IORP II will make a difference, but unravelling our complex arrangements will take time.

~ A Scandinavian pension plan

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[1] Source IPE 'Top 400 asset managers' published in June 2018 and based on AUM as of end December 2017

[2] Amundi figures as of June 30, 2018

[3] Investment hubs: Boston, Dublin, London, Milan, Paris and Tokyo

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