#20 / March 2024

PENSION FUNDS LETTER

Building together smart solutions to face a challenging environment

Trust must be earned

Amundi ASSET MANAGEMENT

Francesca CICERI
Global Head of Institutional Coverage

Sandrine ROUGERON
Global Head of Corporates and Corporate Pension Funds Clients

Natalie BENDELOW
Editor

EXECUTIVE SUMMARY

Looking past short-term noise to the long-term

Our everyday lives are a succession of small decisions. Often unconsciously, we make decisions daily that ultimately influence our longer-term well-being. These range from the seemingly mundane, such as what will we eat, how much will we exercise, in what ways we use our spare cash, to the more significant around professions, relationships and savings. Each of these play a role in our personal aspirations and expectations for the future. Paying attention to seemingly insignificant decisions in the short-term, can deliver results for health, happiness and prosperity in later life. There is also growing recognition that small individual decisions can combine to benefit a wider population, particularly in relation to combatting the climate crisis.

Long-term thinking is central to the pension industry. But greater market uncertainty and volatility are increasingly hindering the short-term decision-making process for pension stakeholders. This dilemma is something we have been discussing with many of you over the past couple of years. It recently formed the main topic of this month's Pension Fund Club digital event, as we try to identify the trends best suited to meeting long-term objectives. A particular focus was responsible investing; a prime example of the need to balance short- and long-term, and a theme that is gaining in importance both at an individual and scheme level for pension investing.

In this edition of the Pension Fund Letter, we continue our discussions on this topic, looking at what it means for different types of pension funds and their KPIs, as well as possible ways of addressing the issue.

We continue with a look at five takeaways from a survey of pension funds on their different approaches to responsible investing and some of the challenges encountered. We have also recently researched how different pension funds approach currency hedging as FX is increasingly considered a source of return enhancement and/or risk mitigation for portfolios. The results can be found in article three.

We wrap up with our usual summary of recent market performance and its impact on funding ratios.

WHAT'S NEW & COMING UP?

13.03.2024
Pension Fund Club
The 2024 event discussing the short-term/long-term balance and responsible investing as a long-term trend.
Watch now

23.04.2024
3pm CET
COMING SOON
Webinar: Capital Market Assumptions
Join the webinar

March 2023
Discover our retirement research
How to define an optimal decumulation strategy
Read the paper

Rudyard EKINDI
Multi-Asset Business Development –
Insurance and Retirement solutions

How can pension funds reconcile short-term volatility and long-term objectives?

PART I. THE PROBLEM AT HAND

Pension funds share a common long-term goal – ensuring that all pension's payments are met for the duration of each pensioner's life. However, different types of pensions schemes are affected by short-term movements, notably volatility, in different ways and their ability and mechanisms to respond also differ. To set the scene, let us consider how short-term volatility affects the three main types of schemes Defined Benefit (DB)[1], Defined Contribution (DC)[2] and Pay-As-You-Go (PAYG)[3] schemes found around the world.

DB schemes

For a DB scheme, a short-term Key Performance Indicator (KPI) is its funding ratio (FR) whilst a long-term one would be its covenant risk[4]. These schemes design a long horizon investment strategy to ensure the projection of its FR remains sufficiently high to secure the payment of anticipated pensions. They must report their funding status to their governing authority (generally on an annual basis). If the FR falls below certain thresholds, a recovery plan is required (that could include a covenant discretionary funding). Ultimately, for instance in the UK, if the scheme becomes insolvent, the assets are transferred to a life boat scheme (the Pension Protection Fund). As a result, **the consequence of short-term volatility for a DB scheme could mean the complete loss of control of its own governance.**

DC schemes

For DC schemes the impact of short-term volatility is different. Generally, contributions are not mandatory. In many European countries, participation in DC pension systems is voluntary. An 'auto-enrolment' mechanism may exist, but with an option to opt-out. As contributions are not compulsory, short-term volatility that negatively impacts performance can deter the membership from contributing, resulting in interrupted contribution sequences. This is harmful over the long-term as **achieving the long-term pensions' objectives relies primarily on regular contributions:** these allow members to fully benefit from compounding and the smoothing of entry points (and therefore performance). Regular contributions are the most efficient risk management mechanism in the accumulation phase of a DC scheme, especially in the event of severe markets swings.

PAYG schemes

PAYG schemes are managed at the government level, whereby workers' contributions pay for retirees' pensions. These schemes rely on two main aspects: the balance between the demographics of different age cohorts and the investment performance to safeguard the pensions reserves. Here **short-term volatility can affect the solvency of the country's pension system as a whole.** If the impact is significant and persistent, coupled with adverse demographic or economic drifts (i.e. expansion of life expectancy or prolonged periods of high unemployment), pension reforms may ultimately be needed, in the form of postponing retirement age, increasing contribution rates, reducing pension provisions, etc. These types of reforms tend to be unpopular from a political and social standpoint.

1. DB scheme make a promise of a level of pension that follows at least the progression of inflation.
2. DC scheme serve a pension that is only the result of accumulated pensions savings, with no indexation to inflation. Collective DC schemes are not explicitly mentioned here, but the principles remain similar with some adjustments.
3. PAYG provides a pension each year to pensioners from contributions of current workers at country level. Workers accumulate retirements points each time they contribute.
4. The risk that the scheme would have to compensate for investment shortfalls in the future.

In summary, why should pension sponsors take short-term volatility into account?

- **DB schemes:** impacts latitude to deploy their investment choices, and may result in loss of governance control.
- **DC schemes:** may cause contribution breaks, severely affecting capacity to achieve long-term objectives, such as the level of replacement income ratio[5].
- **PAYG schemes:** repeated impact (coupled with demographic or economic drifts) can ultimately lead to pension system reform.

PART II. HOW DOES VOLATILITY AFFECT DECISION-MAKING FOR PENSION FUNDS?

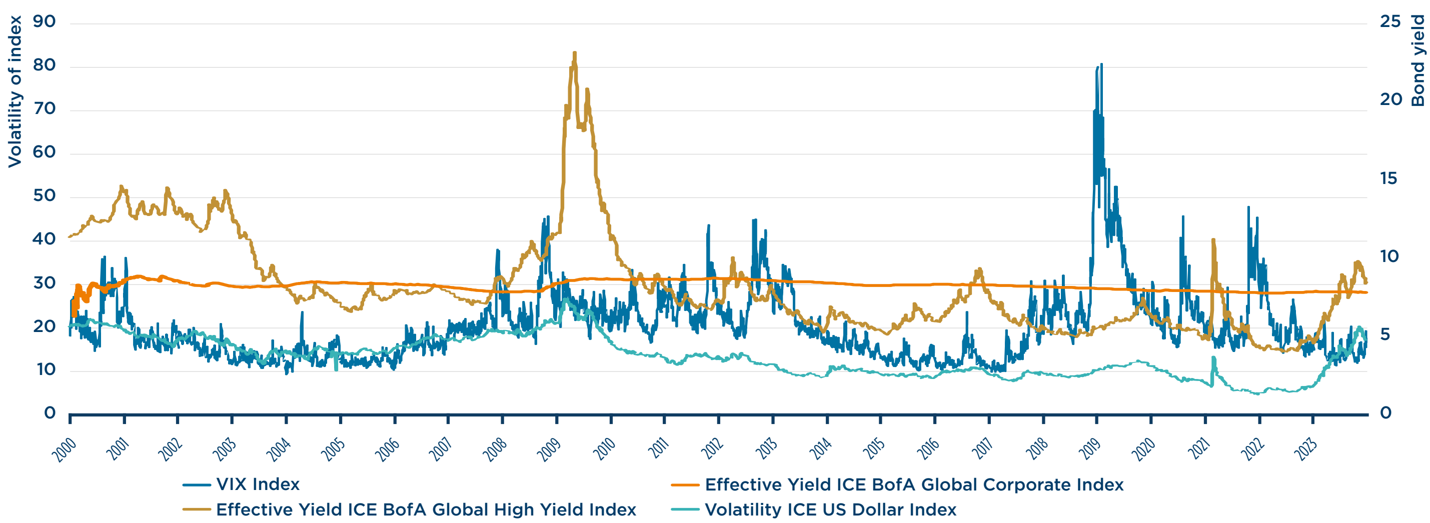
There is no single definition of volatility, nor any industry consensus on what constitutes short-term and long-term volatility for pension funds. For capital markets, volatility represents the standard deviation of an asset's returns. However, over different time periods and time intervals, the resulting volatility can vary significantly.

To make a long-term decision one needs to appreciate what uncertainties lie ahead, or conversely rely on elements that provide stability or reduce uncertainty. Over the long run, volatility actually has a useful attribute: it is stationary. Stationarity means that, over different time horizons, the hierarchy of volatility between asset classes tend to repeat itself. In layman's terms, over the long run, for instance, one can expect that equities are more volatile than bonds, and the relative risk between the two remains proportional.

Understanding this stability aspect (stationarity) of long-term volatility allows pension decision-makers to design more robust long-term investment programs catering for their long-term objectives.

However, in the short-term, it is quite a different story. The hierarchy of volatilities can be quite erratic. In fact, excess volatility may appear to jump from one asset class to another. At times, stocks are very volatile and bonds are seen to provide a safety net (flight to quality), or currencies may be more volatile than usual, and investors look to commodities (gold). Or, as has been the case recently, bonds exhibit higher than usual volatility, taking pension sponsors off guard. Figure 1 illustrates how volatility spikes are not synchronized across asset classes.

Figure 1: Volatility Comparison



Source: Bloomberg, Amundi
Past performance is not a guarantee and does not indicate future results.

In summary:

- **Long-term volatility** may provide stability in the hierarchy between asset classes to allow more robust investment decisions.
- **Short-term volatility** may hinder foresight of how the relative risk of asset classes will be spread, rendering decision-making more uncertain or requiring specific risk management techniques.

5. The ratio of earnings in retirement over earnings during working life.

PART III. WHAT REMUNERATION CAN WE EXPECT FROM HOLDING LONG-TERM RISK?

This question can be reframed as what qualifies as a long-term asset? Additionally, is there a concept of long-term risk premia, meaning an extra expected reward linked with extending the holding period? A long-term asset could be defined either as having a long-term investment horizon (like a bond), or one intended to be held for a long period of time (like strategic equity).

But these definitions are neither accurate nor sufficient in practice. For instance, if one purchases a 30-year government bond but needs to sell it after 5 years, the mark-to-market of the bond can be far from the originally expected average rate of return. If a stock is sold after 15 years at a time of market turmoil, the achieved performance could be flat or even negative.

Let us re-iterate our definition of long-term risk in a way that is useful for a pensions' decision-maker: it relies on reducing uncertainty the longer the investment horizon.

Hence, we can define a framework for assessing long-term risk premia or long-term assets, through two approaches:
- From a risk standpoint, it refers to **an asset where risk (uncertainty) diminishes if held for a long period of time.**
- From a reward standpoint, it refers to **an asset where the expected average (annualised) performance is greater if the asset is held for a long period of time.**

Returning to the example of a 30Y government bond. Clearly, if held to maturity, this bond carries no market risk (apart from default risk). Hence, with an extended holding period, uncertainty has been minimised. In this case, the long-term bond qualifies as a long-term asset (except if sold early).

Taking the example of a 'vanilla' stock. If, for instance, based on analysts' reports at the time of purchase, the annualised expected return of the stock is not estimated to increase if held for 15Y rather than only 10Y[6], such stock would not qualify as a long-term asset (no long-term risk premia). But if analysis shows that extending the holding period can provide additional annualised performance (e.g.: new technology such as AI, electric cars, clean energy and water, or e-commerce few decades ago), then such an investment exhibits long-term risk premia. Private assets, which exhibit the traditional J-curve[7], are also typical candidates for long-term investments.

We can also infer, because of the cyclical nature of stock markets (and assuming mean reversion), that holding stocks for a long period of time reduces uncertainty because even in the case of a crisis, one can wait for a rebound to sell on more favourable terms (indeed this is true for stocks with a sustainable business model). Certain equities may also provide stable streams of cash flow. If so, they meet our risk definition of reducing uncertainty for long holding periods.

PART IV. WHAT IMPACT DO SHORT-TERM KPIS HAVE ON LONG-TERM KPIS?

Examples of long-term stocks

To illustrate the above framework for equities, we consider five stocks from different sectors that exhibit attributes of a long-term asset over the period January 2000-December 2023: **Amazon** (E-commerce), **NextEra Energy** (Green energy), **Tesla** (Electric cars - data since 2010 only), **Nvidia** (Artificial intelligence), **L'Oreal** (Cosmetics).

Figure 2.1: With Nvidia & Tesla

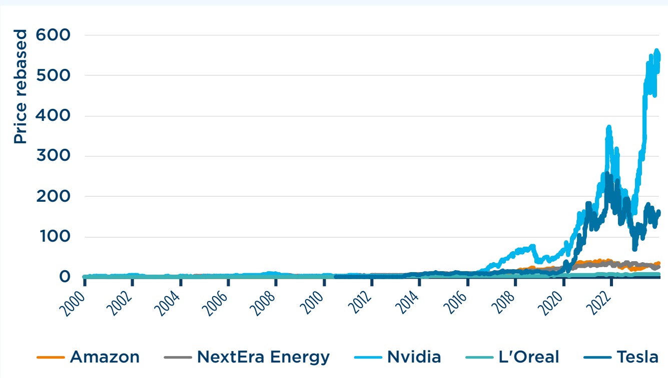
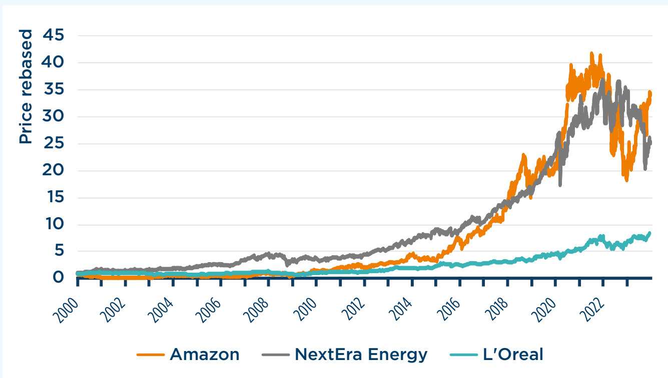


Figure 2.2: Without Nvidia & Tesla



Source: Bloomberg, Amundi
Case studies are for illustrative purposes only, are not a guarantee of outcome and should not be interpreted as advice or recommendation.
Past performance is not a guarantee and does not indicate future results.

6. Considering only the information available at the time of purchase.
7. The J-curve graphs the performance of the investment over time, with a shape like a 'J' because it is low at the beginning and high in the end.

In buying these stocks at the start of the period examined, the first four stocks, (Amazon, NextEra, Tesla and Nvidia) would have qualified as long-term assets as the annualised return after 23Y (13Y for Tesla) is much larger than the annualised return over any period shorter than 15 years (Figure 2.1).

Why include L'Oreal? Figure 2.2 shows a steady trend of performance, and the stock evolves smoothly through the financial crises. This stock meets the long-term risk criteria, i.e. with a longer holding period the (exit) risk is reduced.

If the buy decision had been taken in 2016 or 2018, for the first four stocks their subsequent behaviour would not qualify them as long-term securities. However, L'Oreal appears to be a long-term stock whenever the entry point.

If we assume a minimum 10Y holding period (Figures 3.1 & 3.2) (after purchase in 2000) the annualised cumulative return for all of these stocks increases the longer the holding period.

Figure 3.1: Annualised Cumulative Return with Nvidia & Tesla

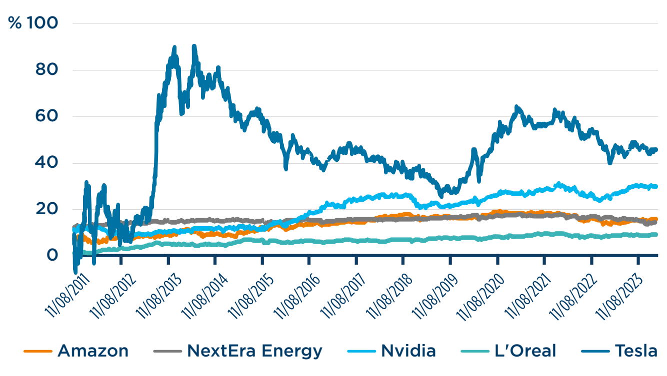
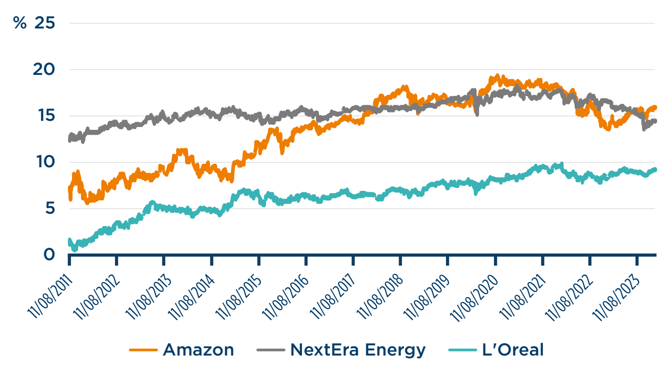


Figure 3.2: Annualised Cumulative Return without Nvidia & Tesla



Source: Bloomberg, Amundi
Case studies are for illustrative purposes only, are not a guarantee of outcome and should not be interpreted as advice or recommendation.
Past performance is not a guarantee and does not indicate future results.

N.B.: This analysis is presented with a look-ahead bias. Analysts must evaluate each stock at the time of purchase, its environment and potential evolution to ascertain whether a stock could be considered a long-term investment.

Figure 4: Examples of retirement KPIs for different types of schemes

	Long-Term KPI	Short-Term KPI
DB	Covenant Risk	Funding Ratio
DC	Replacement Income Ratio	Maximum Drawdown
PAYG	Value of a Retirement Point[8]	Contribution Rate

Source: Amundi

If a DB scheme funding ratio is low, the scheme's sponsor may have to increase its future contributions, resulting in a higher covenant need.

As mentioned in Part I, a large drawdown can deter DC participants from making contributions, meaning it is more difficult to achieve the target replacement income ratio.

In a PAYG scheme, the contribution rate is set by law at the individual level. At the aggregate level (the sum of all contributions of all members) it is a function of factors such as the unemployment rate or GDP growth. Therefore, a lower level of total accumulated contributions can lead a government to reduce the value of a retirement point (or its growth relative to inflation), or alternatively push retirement age. The value of a retirement point can also be affected by lengthening life expectancy.

For each of these scheme types, sponsors need to assess how short-term volatility could impact long-term objectives. Their governance needs to allow for the means to minimise this impact. Short-term volatility cannot totally be avoided, and sometimes is necessary to achieve these objectives. Sponsors must therefore assess what is the actual remuneration from being exposed to short-term volatility.

8. In a PAYG scheme, each contribution gives rights to retirement points. Once in retirement these points are converted into monthly euros to serve the pension applying a value for each point.

PART V. WHAT ARE THE SOLUTIONS FOR PENSIONS' SCHEMES IN THE CURRENT ENVIRONMENT?

*In order **to make long-term investment decisions, pension sponsors need a means to assess the hierarchy of risks over different time horizons, across all asset classes.** Understanding the risks and the associated expected reward guides each phase of the retirement journey. Expectations of pensions' stakeholders have structurally changed: people live longer and in better health[9] significantly changing consumption patterns, governments have extended legal retirement age, growth has shifted from DB to DC, workers and retirees want their pensions' assets to reflect their own convictions such as the environmental transitions and more. These changes, along with an understanding of long-termism in asset selection, can have a significant influence on the design of optimal strategies.*

How does all this influence the design of retirement solutions?

Recent (or future) evolutions

Accumulation phase (decades of working life)

Holding growth assets for longer than traditional glidepaths, which typically fully disinvest growth assets by the end of accumulation period	Relying more on illiquidity premia (even in DC) such as private assets	Need flexibility to access part of the retirement savings	ESG factors, taking advantage of long-term trends

Derisking phase (the last decade before retirement)

Derisking is expected to be gradual, and not necessarily in a straight line -potentially bespoke or path dependent, subject to performance, including some forms of option-based protection	Ability to retain more exposure to growth assets	Loss aversion, requiring downside risk management tools or protection mechanisms

Decumulation phase (years in retirement)

Preserve exposure to growth assets, not just decumulation assets	Flexibility and planning, with regards to distributions and annuity conversion	Flexible use of retirement savings, i.e. for other purposes than retirement	ESG (although not yet a mainstream topic for this phase)

Source: Amundi. Information given for illustrative purposes only, may change without prior notice.

All these expectations require sophisticated solutions design. The pension industry must be to be up to the challenge to accompany the structural changes occurring in the retirement space.

In conclusion, investors need to reflect on how they can reconcile short- and long-term volatility considerations for retirement solutions. While considering long-term aspects is a given, looking at short-term volatility is also a 'must do' for pension schemes. We consider the framework for qualifying long-term and short-term risks and the concept of long-term risk premia. We define some of the long- and short-term KPIs for the main types of pension schemes. This list depends on each pension fund's specific situation. In conclusion, we explore possible implementation avenues, in the form of retirement solutions that aim to manage the impact of short- and long-term volatility on retirement KPIs.

With contributions from

Clément Marsollat

Multi-Asset, Investment Specialist

9. At least in developed countries where pensions systems are largest

Marie BRIÈRE
Head of Investor Intelligence & Academic Partnerships, Amundi Investment Institute

Éric TAZÉ-BERNARD
Senior Advisor, Amundi Investment Institute

Five insights on institutional investors' approach to Responsible Investments

*In the current climate crisis context, **investors have a significant role to play in the transition to a low-carbon economy**. However, many institutional investors are still wondering **how to define their approach** to responsible investing. They are raising many questions such as: **what specific targets can be set** when determining investment and responsible objectives, **how to organise the governance** of investing sustainably, and **what responsible investing strategies can be implemented**. Following qualitative interviews with institutions across continents and conducting a review of academic research and investors' sustainability reports, the results can be summarised into **five key findings**.*

1. Geography, regulation and stakeholders impact responsible investing

There is a wide variation between investors in terms of the degree to which responsible investing and ESG considerations are integrated into investment approaches. **Geography is a key factor** of differentiation, as the **degree of social norms in a country influences local investors' focus** on responsible investment. As an illustration, institutional investors in Europe have a relatively high sensitivity to sustainability investing, while the situation is more heterogeneous in the US, where the debate on ESG matters is politically tainted. Cultural factors also influence the content of institutions' responsible investment policies:

- The E pillar tends to be dominant in Europe.
- US institutions are inclined to focus on social considerations, particularly on the "Diversity and Inclusion" theme.
- Investors in all continents have long considered governance as a key element of their company analysis.

Beyond geography, other factors may impact investors' attitude to responsible investing such as the nature of investors' stakeholders and the structure of pension plans' membership. In particular, the **age of pension beneficiaries** seems to play a role in impacting financial institutions' approaches, as the **younger generations are particularly sensitive to environmental and social issues.**

Regulation is also an important factor[1]. Responsible investing may be **encouraged by regulation,** which investors recognise as a **major driver in improving ESG disclosures** and increasing the integration of sustainability considerations into investment strategies.

The many layers of ESG EU regulation

Source: Amundi. Information given for illustrative purposes only, may change without prior notice.

1. Laugel E., Jaulin T., De Bazin A., Collin J. De Vecchi V.,"Amundi Responsible Investment Views 2024", Amundi.

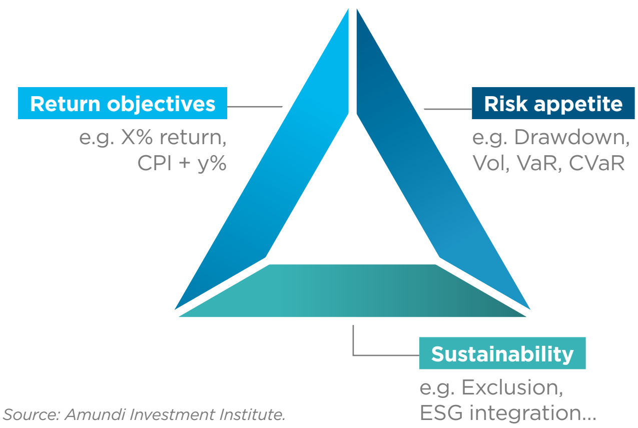
The European regulatory landscape related to responsible investing has considerably expanded in recent years, and **Europe's leading role in regulation** is recognised by investors in other continents. However, for some investors, **regulation is going too far and is becoming too complex.** This is triggering a form of regulatory fatigue, as sustainability regulation already contains a lot of rules which are sometimes seen as redundant or contradictory. Moreover, the relationship between sustainability regulation and investors' approach goes both ways, as local institutions also impact the way in which the regulation is designed to a certain degree. Overall, while sustainability regulations may be partly achieving their objectives, **responsible investment still stands to gain further from increased disclosure requirements.**

2. Responsible investing enhances returns and risk management

Most investors stress that their **fiduciary duty to their stakeholders is to generate return,** and that return is their priority. However, they also generally consider investing sustainably as being **favourable to performance in the long-term.** Moreover, some institutions complement their financial objectives with non-financial ones, convinced that their corporate reputations, which they highly value, can be improved through investing sustainably.

In many cases, responsible investing is also seen as a **key element in investors' risk management approaches.** Climate risk in particular is increasingly integrated within institutions' general risk framework, which many see as holistic, including both financial and non-financial risk sources.

Risk/return/sustainability triangle



Source: Amundi Investment Institute.

Client insight

"We are convinced that paying attention to ESG factors will pay off in terms of risk-adjusted performance in the long-term; for instance, climate regulation will clearly impact the stock prices of companies directly affected by it."

UK defined contribution pension fund

3. Implementation by bottom-up integration with engagement and voting activities

For a number of investors, the **responsible investing journey started with an exclusion policy,** and product-based exclusions are still often present in investors' responsible investment policies. Beyond this, ESG considerations are frequently integrated into investment approaches. They are not defined at the strategic asset allocation level, but essentially are integrated through a bottom-up approach and may result in certain sector and geographical tilts.

In terms of investment implementation, the move to ESG-specific benchmarks tends to remain limited and generally applies to investors' passive portfolios. Most institutional investors also integrate ESG considerations into their manager selection process, generally through detailed sustainability-related questionnaires.

We also observe a **trend towards thematic investing,** with the definition of a portfolio's "green and social" bucket referring to investments in specialised equity strategies, green or social bonds, green infrastructure and low-energy buildings. However, some investors worry about the valuation of these strategies. In addition, those pursuing a net zero objective are also aware that they need to **complement their allocations** to these types of investments **with transition-focused strategies**, both to pressurise companies to decarbonise and to maintain sufficient portfolio diversification.

For this approach to be successful, **engagement is seen as a key pillar,** even though there is some scepticism regarding the success of their engagement. Engagement must indeed be conducted using a highly professional approach, including a definition of objectives, a list of target companies and a clear engagement process. It is vital to include a monitoring step in this process, as **it can take time to achieve results**. Engagement is also an area where coordinated action is an advantage. According to some investors, it may be **more efficient to work at industry rather than at a single company level**.

Another important element is the **voting policy.** Academic research underlines a **positive link between active ownership on responsible investing issues and company performance.** Investors may vote against the re-election of Board members, if climate strategy is not sufficiently addressed, or if some key governance criteria are not met. However, not all investors are equipped to have their own voting policies. A number of them rely on proxy advisors and coordinated actions to influence companies.

4. Divestment can be a last-resort strategy

When engagement and voting are not successful, divestment may be considered, but all surveyed investors mentioned it as a **last-resort instrument that they are reluctant to use**. One explanation is that **divestment would reduce their influence** to improve responsible investing standards and, in particular, climate policies within invested companies.

Divestment can also lead to reduced portfolio diversification, although academic literature overall is not fully conclusive on the effects of divestment. The issue is particularly acute regarding fossil fuel companies. Divestment campaigns are frequent in the non-profit sector where investing in these companies is sometimes seen as immoral or in conflict with an institution's fundamental values.

Client insight

"Abruptly divesting would result in immense volatility and higher tracking errors in investment returns."

Australian pension fund

5. Sustainability governance and resources: data remains a key challenge

Many investors still see **ESG data as a challenge,** in terms of quality, consistency and availability for certain asset classes, particularly private assets that are not easily susceptible to quantifiable criteria. Beyond measurement, there is a debate among investors about whether to apply the same criteria uniformly across markets or to adjust them, for instance, for emerging markets. Furthermore, the reliance of investors on systematic quantitative rating tools is rare, while a number of them are developing climate scenarios to support their climate risk analysis framework.

The importance of the data challenge puts pressure on investors to **expand resources in the sustainability field**, and we observe that the organisation of internal resources varies in this area, between a centralised and decentralised model. In the latter, sustainability issues are discussed in a transversal multi-disciplinary way, underlining the benefits of responsible investing across all functions within institutions.

Client insight

"We engage with companies with high emissions that have sound and realistic business plans to transition to a low-carbon economy within a timeframe deemed acceptable to the Fund."

Australian pension fund

Benjamin BRUDER
Senior OCIO Advisor,
Amundi

Éric TAZÉ-BERNARD
Senior Advisor,
Amundi Investment Institute

Pension funds' currency hedging policy: no one-size-fits all

In a context of low interest rates that has prevailed for a number of years, it can be observed that investors have increasingly considered foreign exchange (FX) as a source of return enhancement and/or risk mitigation for their portfolio, and regulatory trends have generally allowed them more flexibility to do so. ***But how do pension funds around the globe approach this issue of currency (or FX) management?*** *We draw a number of insights from a review of publicly available information, combined with a series of interviews with selected institutions, in which we asked them to describe their FX investment philosophy, process and organisation.*

Regulatory trends

Generally, there has been a trend towards loosening of restrictions on foreign investments for pension funds due to the perceived benefits of international diversification, while at the same time, the related FX exposure limits have proved somewhat more resilient. As an illustration[1], countries like Italy, Sweden, or Switzerland, which impose no restrictions on pension investments abroad, set **firm restrictions on exposure to FX** - respectively 30% in Italy and Switzerland and 40% in Sweden. Other countries rely on the prudent person principle, which usually translates into internal limits specific to each pension fund. Regulatory limits on FX exposure have remained stable in most jurisdictions between 2018 and 2023, and in the few cases where there was a change, it was in the sense of loosening, for instance in Austria, Denmark, Finland, Norway, and Brazil. Pension funds have generally seized these opportunities as the share of foreign assets in pension fund portfolios has increased from about 30% to 35% since 2020, while **more than a third of global public pension and sovereign funds plan to further increase their exposure to foreign markets**[2]. This triggers increased interest in FX as an additional source of return and in outsourcing activity for the implementation of FX management strategies.

FX investment beliefs and philosophy

A majority of investors, and especially the smaller ones, essentially consider FX through their exposure to underlying assets and **do not approach FX as a standalone asset class**. Those that do consider currency as a separate asset class are sophisticated and well-resourced institutions, as **generating alpha through active currency management requires a high level of expertise**. For instance, Future Fund, Australia states that "we explicitly manage the size and nature of the foreign currency exposures rather than allowing them to be shaped by the underlying investments[3]".

> *"We explicitly manage the size and nature of the foreign currency exposures rather than allowing them to be shaped by the underlying investments."*
>
> **Future Fund, Australia**

Most investors tend to set their reference portfolio in the form of a simple mix of equities and bonds, and **FX is generally integrated in this definition in terms of hedging level**. Hence **FX is often an important component of the risk/return definition of strategic portfolios**. As an illustration, for AP2, **FX can be used to minimize portfolio risk** and the hedging level for the strategic portfolio is set to maximize the Sharpe ratio of the portfolio. Meanwhile, AP4 states that their open currency exposure is "mainly owing to a decision from a risk-mitigation perspective".

1. OECD – Annual Survey of Investment Regulation of Pension Providers – 2023 Edition.
2. According to the Official Monetary and Financial Institutions Forum (OMFIF), which survey public pension funds annually.
3. 2022-23%20Future%20Fund%20Annual%20Report%20(1).pdf

Our survey also confirmed that the characteristics of the investor's domestic currency have a strong influence on investor's hedging policy[4]. For instance, the **instability of GBP** observed in recent history **explains a UK pension fund's high level of FX exposure for risk mitigation purposes**. Likewise, certain Canadian pension funds do not hedge much of their exposure to USD in order to diversify away from the **commodities price risk** to which the CAD is sensitive. In more general terms, investors with a **cyclical domestic currency will benefit from risk reduction** when keeping their exposure to USD or JPY unhedged, thereby mitigating the risks of their growth portfolio. On the other hand, investors with a **safe haven domestic currency** will benefit from a risk reduction when hedging their foreign exposure.

In addition, some investors with a low risk aversion and high yielding currencies such as NZD have chosen to hedge their foreign currency exposures, despite the additional risks, due to the very **high carry offered by their domestic currency** compared to foreign currencies. With the recent significant reduction in these spreads, such a stance may be challenged in the future.

FX hedging strategies

The 24-hour FX market is highly liquid and generally reacts quickly to market developments. It provides a huge variety of options for hedging portfolios and reducing embedded volatility. There are several different approaches to this asset class:

- An active and absolute-return approach seeks to make the most of macroeconomic and fiscal policies, as well as technical discrepancies. With a global macroeconomic approach, using robust portfolio construction tools, investors can implement lowly-correlated strategies which aim to play macroeconomic themes such as global or regional recoveries, pro-cyclical currencies and geopolitical tensions.
- Overlay strategies are designed and implemented with targeted levels of FX exposure and calibrated hedging strategies:
  - **Active currency overlay:** uses currencies as an asset class to enhance global portfolio returns. Currencies are rebalanced continuously in favour of those with a better risk-return profile, while applying a predefined risk budget.
  - **Dynamic currency overlay:** designs an optimal hedge ratio reflecting the investor's goal of reducing global portfolio volatility. The optimal hedge ratio is adjusted over time to limit underlying asset volatility.
  - **Passive currency overlay:** defines a specific level of FX exposure in order to reduce the portfolio's currency risk.

Source: Amundi. Information given for illustrative purposes only, may change without prior notice.

FX management: active or passive?

Investors also **tend to adapt their hedging policy to the structure of their asset allocation.** In particular, they will adopt a much higher hedging level for fixed-income than for growth assets[5].

Regarding the degree of activeness, our sample of analysis is relatively evenly **split between** investors that aim at **generating excess return** through active FX management – this is the case of a few Swedish APs and Australian pension funds – and those that **passively manage FX.** This preference may be explained by different factors:
- a belief that no consistent long-term returns may be generated by active FX management,
- a limited FX exposure that does not provide sufficient leeway for effective active management.

In terms of trends, our review of public information suggests that public pension funds have maintained or increased their foreign investments and FX exposure as they looked for new sources of **diversification and return opportunities,** with **a slight momentum towards a more active hedging** approach.

Investment process and organization

Investors active in FX management give priority to medium-term calls, looking to identify sizable valuation gaps based on medium to long-term equilibrium models.

These **active positions are generally few and can be relatively large.** Meanwhile, investors are rather reluctant to use FX as an instrument to gain exposure to certain macroeconomic factors – such as commodity prices - or to actively manage the risk of their portfolio, as they consider there are more direct instruments for this.

> *"It is extremely difficult to add value through active FX management."*
>
> **Austrian Pension Fund**

It is less frequent to see investors implement short-term currency calls as, according to one institution, "it is extremely difficult to add value through active FX management", although some may accept limited leeway upon the

4. This was one of the conclusions of our paper https://research-center.amundi.com/article/currency-hedging-policy-institutions
5. As we stated in the above-mentioned paper.

rebalancing of their portfolio to its strategic target. They may allow an occasional 'step away' from their strategic hedging strategy in order to **take advantage of temporary price dislocations** to add value to the fund. Investors that implement an **active short-term FX management** component need to dedicate significant resources to it, as this is based on market dynamics indicators and requires **constant market monitoring and analysis** as well as **frequent trades with clearly-defined stop losses.** Target FX weights are then generally set in terms of exposure or percentage of total AUM rather than in terms of hedge ratios.

FX exposure linked to investors' portfolio allocation to **alternative assets** may pose particular issues due to **valuation lags** or lack of **real-time transparency.** As mentioned by one of the interviewees, "there is no easy way out" to cope with these issues and one has to accept some level of uncertainty and concentrate on the essential. Progress in obtaining frequent look-through to externally-managed positions and using proxies can help in this respect. External managers are also used by some investors as a source of ideas on FX trends or for the development of FX valuation models.

Exposure to **emerging currencies may be difficult to manage.** In addition, trading these currencies may prove more **costly** or have **limited liquidity.** On this, one investor in search for simplification, uses an equally-weighted and regularly-reviewed basket of 10 currencies to manage its overall allocation to EM currencies.

A few key messages

Investors' approach to currency management should be clearly **linked to the status of their currency and regularly reviewed** along with expectations of the relative performance of their economy.

The most advanced institutions tend to use **FX as a source of risk diversification** for their strategic asset allocation, **design their strategy across well-defined horizons**, and have **formalized their investment process based on valuation models**. Some tactical FX management may be added, based on global market scenarios and on the identification of major valuation dislocations. Internal resources can also be complemented by the advice of external asset managers within established partnerships and potentially delegated mandates.

Jean-Xavier BOURRE
Head of OCIO Investment
Strategy Advisory

Good market performance, but mixed effect on pension funding ratios

The last quarter showed strong performances from assets across the board. Nevertheless, these positive returns merely compensated for the increase in liabilities valuations due to falling discount rates.

	30/06/2023	30/07/2023	30/08/2023	30/09/2023	30/10/2023	30/11/2023	30/12/2023	30/01/2024	29/02/2024
Netherlands	145.80%	146.40%	146.20%	147.50%	147.50%	145.70%	142.80%	143.90%	146.1%
UK	117.80%	120.80%	120.30%	123.20%	121.60%	117.30%	114.60%	115.20%	-
US	100.50%	101.60%	101.80%	102.30%	103.10%	102.00%	100.9%	101.8%	104.3%

Sources: - UK data: Purple Book, PPF S179 funded status. - Netherlands data: Dnb - US data: Aon Pension Risk Tracker.

Positive markets, but uncertainties remain

After a mixed start to the year, February was a positive month with some equity indices at their record high assisted by continued strength in the US economy and positive earnings reports, particularly among some US tech names, boosting the upward momentum. The general **"risk-on" momentum** and positive earnings reports also helped European equities to advance, but European stock markets underperformed notably vs US and Japanese stocks. UK equities were a laggard among developed countries with positive return only reported in the large-cap index.

During the period, **geopolitical concerns persisted** and the attacks from the Houthi rebels on commercial shipping in the Red Sea fuelled further tensions and drove high oil prices higher, after three consecutive monthly declines.

In parallel, with US inflation above target surprising on the upside, growth remaining strong and a generally less dovish tone from Powell, meant the timing of future rate cuts in the U.S were pushed out further in investor expectations. In the FX space, the US dollar strengthened due to delayed and lowered expectations for rate cuts. After a peak in yields in October, the **US yield curve remained inverted** with short maturities experiencing spectacular volatility due to markets reassessing the Fed rate policy pivot after each data release.

In the Eurozone, the European Commission (EC) **cut its forecast** for Eurozone economic growth in 2024 to 0.8% from the 1.2% predicted in November. This downward revision reflected higher levels of inflation, which have eroded purchasing power, and higher interest rates, which curbed credit appetite. Separately, the second GDP estimate confirmed that the economy stagnated in the fourth quarter of last year, after shrinking 0.1% in the previous three months. Senior European Central Bank officials continued to warn against cutting interest rates too early, and the ECB also noted that **risks to economic growth remained tilted to the downside**. In this environment, the German yield curve also remained inverted with rising yields along the curves and larger moves seen in short-term maturities as investors trimmed bets on the number of interest rate cuts this year.

In the UK, official data showed that the UK economy fell technically into recession in Q4 and that inflation held steady in January reviving market expectations that the Bank of England could cut interest rates as soon as June. The UK labour market remained relatively tight with the unemployment rate declining to 3.8% in the fourth quarter of 2023.

As far as the credit markets are concerned, performance was positive on both sides of the Atlantic and across the board as IG indices tightened by 3 to 5 bps and HY indices 5 to 15 bps since year end. Pension assets were slightly caught up by liabilities.

In this context, pension funds' assets were supported by positive performances on equities and fixed income securities. This was counterbalanced by the lower interest rate environment that have pushed liabilities valuation higher. As a consequence, although the **funding situation remains very healthy** and close to historical highs in all jurisdictions, **funding ratios deteriorated slightly in recent months**.

The Dutch pensions evolution continues

In the Netherlands, the pension market is still animated by significant structural and circumstantial changes:

- The transition to the new Ultimate Forward Rate methodology[1] reached its **final step in January 2024**, ending the progressive adjustment of the liabilities discount curve toward a reference closer to market levels.
- The improvement of funding ratio in recent months has triggered a **re-indexation of pension to inflation** after more than a decade of status quo[2]. Several funds have already announced that they will continue to increase pensions in 2024. The market is meanwhile not expecting a movement as large as that experienced in 2023.
- While the **transition** from a defined benefit to a defined contribution system is making **gradual progress**[3] and a lot of discussion and negotiation are happening between pensioners, unions, pension fund administrators and legislators, most of the funds **will not shift to the new system before 2025**, if not 2026, while the transition process is expected to be completed on Jan 1st 2028.

1. See Pension Fund Letter #11 (May 2011) https://research-center.amundi.com/files/nuxeo/dl/f6a8e3c0-a1d4-4f45-8c0e-ab070f41b953
2. See Pension Funds Letter #18 https://research-center.amundi.com/article/amundi-pension-funds-letter-ndeg18
3. See Pension Funds Letter #18 https://research-center.amundi.com/article/amundi-pension-funds-letter-ndeg18

CROSS ASSET Investment Strategy

MAIN AND ALTERNATIVE SCENARIOS

	PROBABILITY **70%** **MAIN SCENARIO** Slowdow in global growth	PROBABILITY **20%** **DOWNSIDE SCENARIO** Global downturn	PROBABILITY **10%** **UPSIDE SCENARIO** Economic resilience
GEOPOLITICS	• Ukraine/Russia: ongoing fighting (ceasefire less likely). • Israel: Conflict likely to stay local. • China/US: a controlled downward trajectory. • More protectionism, friend-shoring.	• Worsening Ukraine war. • Extension of the conflict in the Middle East / Red Sea. • More protectionism and increased retaliation to protectionist measures.	• De-escalation /ceasefire in Ukraine. • End of the Israel /Hamas war. • Lower energy / food prices.
INFLATION & POLICY MIX	• Inflation to slow; sticky core inflation (services). • DM CBs: no urgency to cut rates. Fed funds rate -100bp by end-24, ECB -125bp. • Most EM CBs at peak rates. • Different fiscal policies. restrictive stance in the EU, negative impulse in the US; moderate measures in China.	• Sticky core inflation leads to tighter financial conditions. • Financial stress. • Recession to drive rate cuts (large rate cuts in case of deep recession).	• Gradual reduction of interest rates, but fewer rate cuts than in the central scenario.
GROWTH PATH	• Global slowdown with sharp divergences: very anaemic growth in Europe; a slowdown in the US; faster transition to lower growth in China. • Growth gap favour EM.	• More widely spread recessionary outlook (global growth below 2%).	• Only a pronounced cyclical disinflation, could lead to a faster-than-expected return to potential growth in 2024 in Europe.
CLIMATE CHANGE	• Climate change hampers growth and exacerbates stagflationary trends.	• Further delays with more adverse climate events.	• Orderly transition coordinated across regions.

RISKS TO CENTRAL SCENARIO

LOW — PROBABILITY — HIGH

	15% **Stagflationary pressure persists (US / Europe)**	15% **Deep profit recession**	15% **Macro financial risks triggered by tighter credit and liquidity conditions**	25% **Geopolitical risk and war escalation**
MARKET IMPACT – Positive	For TIPS, gold, commodity FX and real assets	For cash, JPY, gold, quality vs growth and defensives vs cyclicals	For US Treasuries, cash and gold	For DM govies, cash, gold, USD, volatility, defensive assets and oil
MARKET IMPACT – Negative	For bonds, equities, DM FX and EM assets	For risky assets and commodity exporters	For credit	For credit, equities and EM

Source: Amundi Investment Institute as of March 2024.
DM: developed markets. EM: emerging markets. CB: central banks. USD: US dollar. TIPS: Treasury inflation-protected securities. FX: foreign exchange markets.

CROSS ASSET Investment Strategy

AMUNDI ASSET CLASS VIEWS

In focus this month

- **US mega caps:** We are sceptical on the mega-caps and believe there are opportunities outside this segment, including in US Value. On Global Growth, we are close to neutral.
- **UK govies:** Headline inflation is likely to fall quickly and a majority in the Bank of England's Monetary Policy Committee appear to be in the rate-cut camp. Thus, we are slightly positive on Gilts.

Equity and global factors

REGIONS	Change vs M-1	--	-	=	+	++
US				●		
Europe				●		
Japan					●	
EM					●	
China				●		
EM ex China					●	
India					●	

GLOBAL FACTORS	Change vs M-1	--	-	=	+	++
Growth				●		
Value				●		
Small caps				●		
Quality					●	
Low Volatility				●		
Momentum				●		
High Dividend					●	

Fixed income & FX

GOVIES	Change vs M-1	--	-	=	+	++
US					●	
EU core				●		
EU periph.				●		
UK					●	
Japan			●			

CREDIT	Change vs M-1	--	-	=	+	++
US IG				●		
US HY			●			
EU IG					●	
EU HY			●			

EM BONDS	Change vs M-1	--	-	=	+	++
China govt.				●		
India govt.				●		
EM HC					●	
EM LC					●	
EM corp.					●	

FX	Change vs M-1	--	-	=	+	++
USD					●	
EUR			●			
GBP			●			
JPY					●	
CNY			●			

Source: Amundi, February 2024. Views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.

▼ Downgrade vs previous mont
▲ Upgraded vs previous month

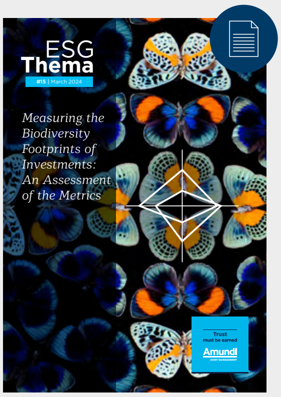
To go further: The Amundi Research Center

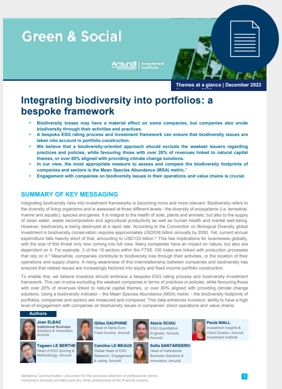
Amundi Investment Institute

In an increasing complex and changing world, investors need to better understand their environment and the evolution of investment practices in order to define their asset allocation and help construct their portfolios. This environment spans across economic, financial, geopolitical, societal and environmental dimensions. To help meet this need, Amundi has created the Amundi Investment Institute. This independent research platform brings together Amundi's research, market strategy, investment themes and asset allocation advisory activities under one umbrella; **the Amundi Investment Institute**. Its aim is to produce and disseminate research and Thought Leadership publications which anticipate and innovate for the benefit of investment teams and clients alike.

To find out more, please visit: **research-center.amundi.com**

ESG and Net zero





2024 Responsible Investment Views

Thematic Papers

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