#13 / December 2021

PENSION FUNDS LETTER

Confidence must be earned
Amundi
ASSET MANAGEMENT

Building together smart solutions to face a challenging environment

Alexander PREININGER
Global Head of Institutional Coverage

Sandrine ROUGERON
Global Head of Corporates and Corporate Pension Funds Clients

EXECUTIVE SUMMARY

A defining moment for pension funds?

When we reflect back on 2021 in years to come, will we see it as a turning point leading to fundamental change in the way we live, a missed opportunity, or merely an interlude before "ordinary" life continues? No matter the outcome, in the here and now, our societal norms and practices, from politics, consumption habits, working practices, and even well-established financial narratives appear under ever-increasing scrutiny.

The COP26 was a focal point for much of this attention. While the summit was generally recognized as a success, it remains to be seen whether the commitments made in Glasgow will successfully change our course onto a sustainable pathway.

As the Amundi-CREATE report shows, asset owners, such as pension funds, have participated considerably to the growth in ESG investing and their role will only expand if we are to meet the financing needs outlined at COP26 that will be required to fight climate change, support the energy transition and meet net-zero targets. At the same time, deep-seated inequalities exposed by the pandemic need to be addressed.

Pensions are also facing their own critical juncture, with the pandemic only compounding the already complex combination of ageing demographics and low interest rates in their impact on pension finances. This leaves many with the dilemma of how to find a balance between discharging their pension obligations whilst also looking to reduce deficits.

The demographic challenges faced by pension funds highlighted by the Amundi-CREATE report are formidable and in addition, many of the long-term consequences of COVID-19 are yet to be fully understood. It is however clear that pension schemes have to prepare for radical changes, both led by political reform and from sustained lower growth prospects, after facing a worsening environment for years. One clear sign of this evolution is the increasing number of Defined Benefit (DB) plans, whose days are numbered according to many considering switches, to Defined Contribution (DC).

As we prepare to step into 2022, it's not merely the world at large, but also pension funds that need to make some difficult decisions about our future. But we should not forget there is no challenge too big that cannot be overcome through collective effort.

Amin RAJAN
Chief Executive
Officer of CREATE

DB plans in their End Game in the post-pandemic era

An inopportune toxic confluence of three unrelated forces has badly undermined the finances of employer-sponsored defined benefit pension plans.

The first is ageing demographics: ever larger cohorts of post-war Baby Boomers have entered their golden years since the start of the last decade.

The second is regulation. Across all the key pension markets, pension plans have been enjoined to prepare for their End Game: showing how they intend to meet their fast-maturing pension obligations.

The third is interest rates. These have been falling under the central bank quantitative easing programmes that followed the Global Financial Crisis of 2008. They have reduced funding ratios by inflating the present value of plan liabilities and also hit the interest income used to fund regular pay-outs.

The latest round of zero-bound rates – accompanying an unprecedented fiscal stimulus worth 25% of global GDP to fight the Covid-19 crisis in 2020 – has made a bad situation worse for most DB plans worldwide. They went into the crisis with their finances in far worse shape than they were in the 2008 crisis. Now they are caught in a Catch-22: they cannot afford to take risks with persistent deficits in a maturing plan; nor can they cut deficits without doing so.

Accordingly, our 2021 annual Amundi–CREATE pension survey aims to find out how DB plans are juggling conflicting priorities at a time when asset values are trading at nosebleed levels that are far removed from reality.

The pandemic is the catalyst that will trigger inflation

Covid-19 marks a watershed: the Thatcher– Reagan free market philosophy that long dominated public policy in the West is likely to be replaced by rising governmental intervention, according to 53% of our survey respondents (Figure 1.1). The pandemic has exposed and amplified deep-seated inequalities in all walks of life. Taxes and wages are expected to rise, in response.

The unprecedented policy stimulus in 2020 will likely trigger key shifts in the global economy: from deflation to inflation (58%), from deregulation to over-regulation (45%) and from rising inequalities to mandated redistribution of income and wealth (40%).

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

Interview quotes

"As inflation accelerates, central banks have to choose between tackling it with rate rises or controlling the yield curve. They can't do both."

"Nobody knows the true scale of the damage to the productive base of the global economy.
It's hard to believe that it will simply snap back."

Source: Amundi Asset Management/CREATE-Research Survey 2021

Hence, central banks' independence in rate setting and inflation targeting is no longer sacrosanct, as governmental agenda takes priority – 39% cite it as 'likely' and a further 45% say 'maybe'. The long-prevailing Goldilocks era of moderate growth/low inflation in the global economy may soon be over.

A clash between massive policy stimulus and unquantifiable damage to the productive base of the global economy during worldwide lockdowns has already sparked an inflationary spiral that will be more than a temporary blip.

Inflation expectations may well become unanchored under the more permissive inflation target of the US Federal Reserve, presenting three choices regarding its ultra-loose monetary policy: a timely exit, a delayed exit or a chaotic exit.

Each option conflicts with two tacit policy goals of the Fed: first, keeping rates very low at both ends of the yield curve to fund governments' ballooning debt; second, relying on rising inflation to shrink the resulting global debt mountain. The scope for policy missteps is huge.

Indeed, 56% of our respondents expect rates to rise over the next three years either due to market forces or overt central bank action. Either way, they will affect investment returns, since rates are embedded in and contribute to every asset class's expected returns owing to their influence on economic growth and inflation expectations.

In this scenario, 71% expect investment returns to be a lot lower, as the last decade's artificially inflated asset price boom finally unwinds. Many among them also believe that today's asset prices are far removed from reality. They will likely reconnect with their fundamentals, as central banks' influence on asset prices begins to wane.

Ageing demographics have pushed DB plans to their End Game, amplified by the challenges of the pandemic

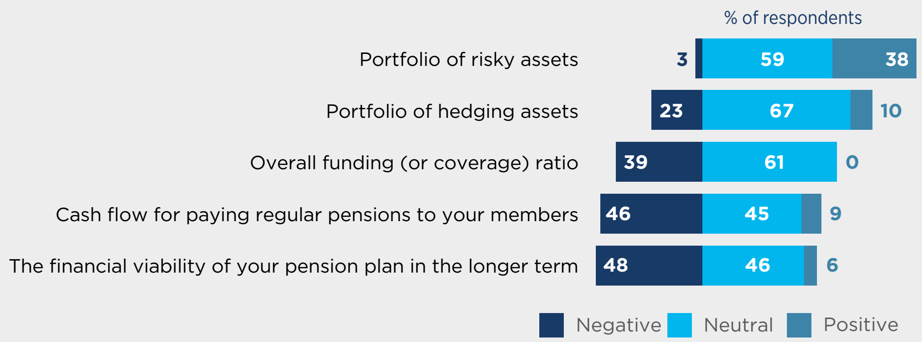
The Covid-19 crisis has hit pension finances. 48% of our survey respondents report that the impact of the pandemic on the financial viability of their plan has been 'negative' while only 6% think it has been 'positive' (Figure 1.2). The impact on funding ratios and regular cash flows has also been net-negative, 39% report a 'negative' impact on the overall funding ratio, while 0% report it as 'positive'; and 46% report a 'negative' impact on cash flow for paying regular pensions, while 9% report a 'positive' impact.

About the only area where a net positive impact is evident is in the portfolio of risky assets. As the post-pandemic market bounce turned into the mother of all rallies in 2020, 38% reported a 'positive' impact and only 3% reported a 'negative' impact.

The crisis couldn't have come at a worse time for defined benefit pension plans, as ageing demographics have long been driving most of them into their End Game: where they are obliged by regulators to show how they intend to discharge their maturing pension obligations. 71% of respondents expect to use solutions that rely on their own balance sheet, while the rest aim to rely on off-balance sheet solutions mainly via pension buy-out and buy-in from insurance companies.

With ageing demographics, capital conservation has become a top priority in order to meet pension commitments. While asset valuations remain artificially high, pension plans worry about the time needed for a portfolio to recover after a big drawdown. A long recovery period could hamper the ability to meet the maturing liabilities.

Figure 1.2 - What has been the net impact of Covid-19 on various aspects of your pension plan so far?



Interview quotes

"The pandemic's negative effects on pension finances will linger on for a long time."

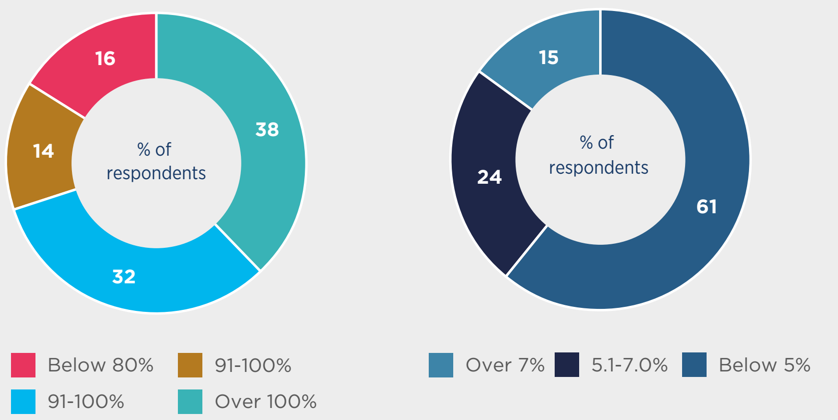
"Is the 40-year bond bull market coming to an end? Yes, perhaps or maybe not."

Source: Amundi Asset Management/CREATE-Research Survey 2021

Only 38% of our respondents have a ratio above the statutory requirement of 100% in most pension markets. At the other extreme, 30% have a ratio below 90%.

To bridge the gap, the annual returns net of fees required in their portfolios vary (Figure 1.3. right chart). 61% need less than 5%, 24% need 5–7% and the remaining 15% need over 7%.

Figure 1.3 - What is your current approximate funding (or coverage) ratio?
What annual returns on your investments would meet your long-term funding needs?



Interview quotes

"Our plan sponsor worries about going into risky assets when they seem so overpriced."

"The End Game is challenging when you have negative cash flow and a funding deficit."

Source: Amundi Asset Management/CREATE-Research Survey 2021

The toxic mix of regulation, ageing demographics and low rates has pushed the majority of defined benefit plans into a Catch-22 situation: they can't afford to take a risks with rising deficits in a maturing plan; nor can they cut deficits without taking risks. Indeed, 32% of our respondents expect to increase risk, 41% expect to decrease it and the rest to leave it static.

Increasing allocations to riskier assets could potentially deliver higher returns. But this is counterintuitive from the perspective of the End Game, as envisaged by regulators, who worry that risk does not always generate returns, especially while markets are so distorted by central bank action.

The twilight years of DB schemes

Falling interest rates since the 2008 crisis played havoc with DB plans. The latest fall, which occurred in the wake of the pandemic is the final blow in a long saga that has made these plans ruinously expensive for their corporate sponsors. Worldwide, DB schemes are becoming the preserve of the public sector, thanks to taxpayer backstops.

Among our survey respondents, 60% are closing their DB plans and seeking to move existing members to DC plans. 54% are seeking additional cash injections from their sponsors to repair their finances at a time when sponsors themselves have been hit by lockdowns. And 49% are seeking to extend their recovery periods.

It is still early days for DC plans. Currently, most are still in the asset accumulation phase, like DB plans 15 years ago. There are fears that, without rising stock markets, many of today's DC plans will face unfunded 'shadow' liabilities and come to suffer the same fate as their DB peers.

Providing affordable pensions means blending caution with opportunism

The risk–return trade-off has become more acute as cash flows have turned negative for an ever-increasing number of plans: where regular pay-outs to pensioners exceed contributions from sponsors, members and investment income. Currently, 33% of our respondents have 'positive' cash flow, 19% have 'neutral' and 48% have 'negative'.

Rising interest rates can help the matter by reducing plan liabilities: 19% regard their impact as 'positive' and a further 50% regard it as 'somewhat positive'. For many plans, that remains their best hope, even though the next rate-hiking cycle will likely be even more subdued than the last one, during 2015–18, given the current global debt overhang.

Given the agnostic need to earn decent returns in the face of funding deficits, our survey respondents are left to strike a balance between three conflicting aims in their End Game: generating returns to improve the funding ratio, reducing risk relative to liabilities and facing rising cash flows as ever more members retire. That means dividing their portfolios into three buckets: return-seeking assets, hedging assets and crossover assets (Figure 1.4).

However, a big concern currently is that inflation and rising rates could hit hedging assets just when they are needed to de-risk the equities that target high returns. As portfolio ballast, bonds now have limited capacity to make up for stock market losses in a downturn. They are also more vulnerable to a rapid sell- off if inflation gathers pace.

Figure 1.4 - Over the next 3–5 years, which of the following asset classes will be most suited to delivering the End Game of your pension plan?

Return seeking assets	% of respondents	Cross-over assets	% of respondents	Hedging assets	% of respondents
Global equities	63	Infrastructure	59	European IG corporate bonds	48
EM equities	57	Real estate	56	EM IG corporate bonds	44
Tactical asset allocation	44	High quality equities	53	Private debt	39
European equities	43	Private equity	48	European government bonds	33
US equities	29	High yield bonds	42	US IG corporate bonds	27
Small cap equities	23	Commodities (excl. gold)	38		

Asset growth ← → Liability matching

Interview quotes

"Cross-over assets target capital growth, income and inflation protection."

"IG corporate bonds help to immunise time-based tranches of liabilities."

Source: Amundi Asset Management/CREATE-Research Survey 2021

ESG investing shifted firmly from niche to mainstream

Covid-19 has starkly exposed deep-seated income and wealth inequalities as well as environmental degradation and demonstrated that ESG objectives no longer come at the expense of financial returns; in fact, it's quite the reverse.

The social pillar of ESG in particular received a significant boost from the pandemic, as it vividly highlighted how the sustainable economies on which markets depend require sustainable societies. The presence of the 'gig economy' has long concealed deep-rooted structural instability in our societies. The social pillar is now seen as being closely tied to intangible assets that affect stock prices. How companies treat their employees is now used as a proxy for their ability to withstand unforeseen shocks in the future.

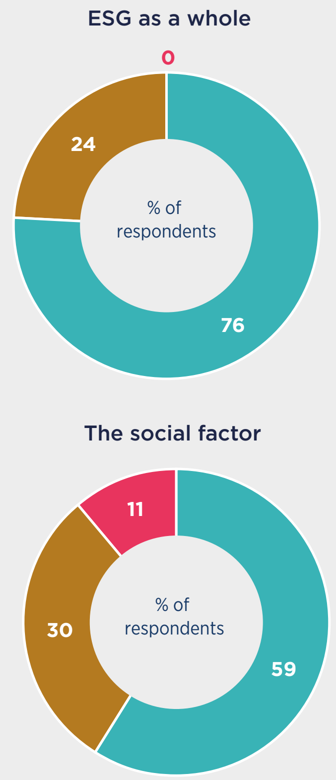
Survey results show that the social pillar of ESG has gained traction: 32% regard it as the most important in the post-pandemic era, up by 2% since 2020. In turn, the respective figures for environment and governance are 43% and 25%.

ESG investing has matured to the point where pension plans are demanding hard evidence of physical impact on the ground that goes beyond the good performance numbers delivered thus far. Current allocations are likely to rise over the next 3–5 years (Figure 1.5) – to ESG as a whole (76%) and to the social pillar (59%).

It is widely expected that the cultural and legal norms around ESG will take root in the financial market ecosystem such that, over time, they become part of business best practice to deal with negative externalities.

We believe that, in taking stock of the current pension fund state of mind in Europe in a particularly difficult and evolving environment, our 2021 Amundi Create survey highlights many issues of interest that will be the basis for future themes to be addressed in the next Amundi Pension Fund Letters.

Figure 1.5 - How will the allocation percentage change over the next 3–5 years as a result of the pandemic crisis?



Decrease | Remain static | Increase

Interview quotes

"ESG investing is now about capitalising on opportunities, minimising risks and making quantifiable impacts."

"ESG is reshaping the ecosystem of financial markets, as societies develop zero tolerance towards negative externalities."

Source: Amundi Asset Management/CREATE-Research Survey 2021

Amundi-CREATE 2021 survey: Highlights

(% of pension plan respondents)

Changes in the macro regime

58%
There will be a shift from deflation to inflation as supply bottlenecks appear in economic recoveries

39%
Central banks' independence will erode as they embrace governments' post-pandemic agenda

56%
Interest rates will rise structurally as central banks lose credibility in influencing asset prices and controlling market volatility

71%
Asset returns will be a lot lower, as the artificially inflated boom of the last decade unwinds

Changes as ageing demographics ushers in the End Game

48%
The pandemic has undermined pension plans' viability in the longer term

41%
Ageing demographics will reduce the overall risk appetite, while promoting selective re-risking

48%
Plans are in negative cash flow territory

60%
Sponsors are closing their DB plans and migrating to DC plans

Asset allocation

62%
Funding levels are below 100%, requiring risk taking

63%
Will rely on global equities to narrow funding gaps

48%
Will rely on European IG credit to provide the necessary cash flow

59%
Will rely on infrastructure to deliver yield and inflation protection

ESG investing

67%
Target good risk-adjusted returns from their ESG investing

50%
ESG funds performed better than the rest of the portfolio since the market crash in 2020

76%
Allocations to ESG will grow over the next three years, as markets are forced to price in negative externalities

59%
Allocations to the social pillar will grow over the next three years, as governments tackle inequalities

About the survey: each year, Amundi and CREATE interview pension plans to highlight insightful convictions for the year to come. The 2021 edition aims to find out how DB plans are juggling with conflicting priorities at a time when asset values are trading at nosebleed levels that are far removed from reality. Taking a 3-year forward view, the survey pursued four lines of enquiry:

- Which macro shifts are likely in the post-pandemic global economy?
- How are the dynamics of the End Game being played out and what challenges are being addressed?
- Why has cash flow driven investing (CDI) dominated asset allocation?
- What outcomes have thus far been delivered by ESG investing and what are the expectations post-COP26?

The survey is based on 152 respondents from 17 pension markets, collectively managing €2.1 trillion of assets.

Read the full Amundi-CREATE report


Sofia SANTARSIERO
Business Solutions and Innovation Analyst

Timothée JAULIN
Head of ESG Business Development and Advisory

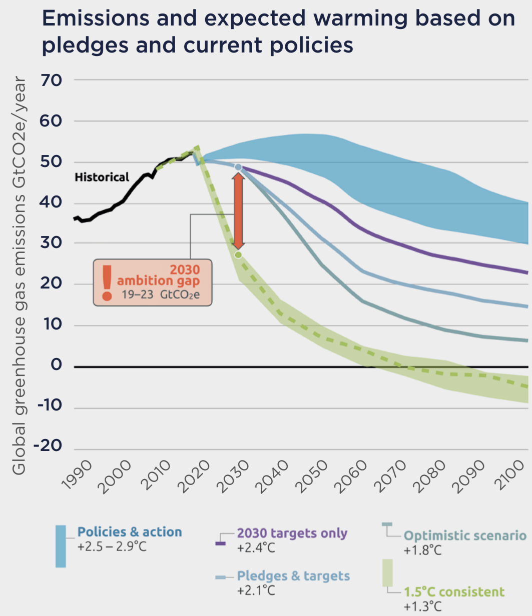
COP 26: A pivotal role for pension funds towards Net Zero

1. COP26: are we moving fast enough?

The Conference of the Parties (COP) was established with the adoption of the United Nations Framework Convention on Climate Change (UNFCCC) at the Earth Summit in Rio de Janeiro in 1992.

Since the first COP in 1995 headed by the then environmental minister of Germany, Angela Merkel, the way world leaders think about climate change has fundamentally changed. The arguably most groundbreaking contribution to this was the 2015 Paris agreement, committing the world to limit global warming to well below 2°C and to pursue efforts toward a 1.5°C trajectory. COP26 which took place between October 31st and November 12th in Glasgow, Scotland has been described as the last chance to avert the most serious negative impacts of climate change. The current policies are likely to lead to global warming between 2.7 and 3.1°C by the end of the century, far off the 1.5°C trajectory.

2100 warming projections



Source: climateactiontracker.org/global/temperatures

COP26 had four main goals to achieve:

1. Securing global net zero by 2050
- Countries must accelerate the phase-out of coal, curb deforestation and speed up the transition to greener economies.
- Countries' carbon market mechanisms are also part of the negotiations (Article 6 of the Paris Agreement).

2. Adapting to protect communities and natural habitats
- Countries already affected by climate change must protect and restore ecosystems, as well as build resilient defenses, warning systems, and infrastructure.

3. Mobilizing finance
- International financial institutions have a key role in securing funds for the transition.

4. Working together to deliver
- Collaborations between governments, businesses and civil society need to be established to make the Paris agreement fully operational.

Several commitments across the four objectives of the COP26 outlined above became concrete outcomes of the event, as we discussed here.[1] While they are all relevant for our future economies and societies and thus for long-term investors such as pension funds, the focus of this article will be on the particular initiatives that have pension funds as protagonists.

1. https://research-center.amundi.com/article/esg-thema-special-cop26-paris-glasgow-are-we-moving-fast-enough

Initiative 1: Leading financial institutions committed to tackling deforestation

33 financial institutions, including the Church of England Pension Fund, with $8.7 trillion in assets under management, agreed to phase out agricultural commodity-driven deforestation risks from their investment and lending portfolios by 2025.[2]

Institutions making these commitments recognize that "tackling deforestation is crucial to meeting their net zero targets as well as addressing the growing ESG, market, reputational and litigation-related risks associated with the value chains of these agricultural commodities".[3]

Initiative 2: The Glasgow Financial Alliance for Net Zero

The Glasgow Financial Alliance for Net Zero (GFANZ), representing $130 trillion (vs $5 trillion at the beginning of 2021) in capital across 450 financial institutions in 45 countries, announced that they have committed to transforming the economy and achieving net zero by 2050 by delivering the estimated $100 trillion of finance needed over the next three decades.

GFANZ comprises banks, asset managers, asset owners (including pension funds), financial service providers and consultants through the Net-Zero Banking Alliance, the Net Zero Asset Managers initiative, the Net-Zero Asset Owner Alliance, the Paris Aligned Investment Initiative, the Net-Zero Insurance Alliance, the Net Zero Financial Service Providers Alliance and the Net Zero Investment Consultants Initiative.

Over 90 of the founding institutions (both asset owners and asset managers) of GFANZ have already delivered on setting short-term targets. GFANZ signatories also commit to forming a Task Force on Climate-Related Financial Disclosure (TCFD) disclosures, which include climate stress-testing their own activities, and to creating science-based transitions plans. Indeed, the GFANZ report mentions that "a key step in decarbonizing finance is to develop common industry standards and best practices on how to measure alignment with the Paris Objectives. [...] They are crucial for bringing a forward-looking view to a counterparty's future emissions and its level of alignment to net zero".[4]

Initiative 3: Public climate finance for developing countries

After falling more than $20 billion short of $100 billion pledged during COP15 in Copenhagen, this time at COP26, developed countries committed to ambitious climate finance plans, further increasing their deployment of money to developing countries by 50% on average.

For example, over the 2021-2027 period, budget from European Commission to support climate action in developing countries will exceed €28 billion. The United States also intends to further double its annual public climate finance to developing countries to around $11.4 billion by 2024.

However, there is a clear mismatch between demand for financing and available supply from public sources. Asset owners in developed markets, including large pension funds, are thus increasingly being asked to step in.[6]

2. COP26: implications for pension funds

As outlined in the results of the Amundi-CREATE 2021 report, ESG investing is no longer considered niche for pension funds. Instead, it has gone full mainstream and it has become a "foundational" trend in pension portfolios, also given its over performance during the crisis vs non-ESG portfolios. While the COVID-19 pandemic has focused the spotlight on the "social" pillar, which has experienced a major rise in ESG concerns among pension funds', the "environmental" pillar is still considered the most relevant component for investing in the next years, due to its broadly encompassing impacts.

Moreover, pension funds tend to allocate to the "E" pillar specifically instead of approaching it in a broader ESG sense, contrarily to what is currently done with the "S" pillar.

Overall, climate change is perceived both as a risk and an opportunity, and pension funds have started acting upon it.

In fact, in the context of the COP26, pension funds have increased their commitments to fight climate change, even beyond the "official" outcomes of the summit. For example, pension funds located in the Nordics, Greenland and the United Kingdom, supported by their governments, have committed to investing $130 billion by 2030 in clean energy and climate investments.[7]

Also, representatives from the UK, the COP26 "host" country, have encouraged other governments globally to use their pensions as a "superpower" in delivering Net Zero[8].

2 https://www.thomsonreuters.com/en-us/posts/news-and-media/cop26-deforestation-methane-pledges/
3 https://racetozero.unfccc.int/leading-financial-institutions-commit-to-actively-tackle-deforestation/
4 https://www.gfanzero.com/press/amount-of-finance-committed-to-achieving-1-5c-now-at-scale-needed-to-deliver-the-transition/
5 https://ukcop26.org/wp-content/uploads/2021/11/Table-of-climate-finance-commitments-November-2021.pdf
6 https://www.thethirdpole.net/en/climate/missing-finance-developing-countries-cop26/
7 https://stateofgreen.com/en/partners/state-of-green/news/nordic-and-uk-pension-funds-commit-us130-billion-in-climate-investments-by-2030/
8 https://www.pensionsage.com/pa/COP26-World-leaders-urged-to-use-pensions-superpower.php

Indeed, the UK government has unveiled sustainability disclosure requirements (SDRs) for pension funds, among other financial institutions, in its "Greening Finance: A Roadmap to Sustainable Investing", on top of the already planned TCFD recommendations.[9] More of such regulations, policies and initiatives can be expected in the months to come.

Before the COP26, the world was on track for a 2.7°C rise in temperatures by the end of the century. Thanks to the commitments announced, this scenario now looks very different.

According to the International Energy Association (IEA), the COP26 pledges will put the world on track for 1.8°C warming by the end of the century.[10]

However, to get there, it is estimated that $5 trillion in new equity and debt investment is required each year between now and 2050 to fund the transition of key industries such as energy, transportation, and manufacturing.[11] Pension funds, the world's biggest asset owner group, are thus in an optimal position to provide part of the needed financing for the "Race to Net Zero".

READ MORE
ON THE TOPIC

This edition provides additional insights and analysis on key pledges taken at COP26, as well as on the implications of these achievements for institutional investors.

It focuses particularly on:
- *The Global Methane Pledge*
- *The transition from coal to clean power*
- *The Deforestation Pledge*

Read the paper online

9 https://www.pionline.com/esg/uk-outlines-sustainability-disclosure-rules-new-report
10 https://www.reuters.com/business/cop/net-zero-methane-pledges-push-world-near-paris-climate-goal-iea-2021-11-04/
11 https://www.bcg.com/publications/2021/how-asset-owners-can-lead-the-net-zero-emissions-race

Karin FRANCERIES
Head of OCIO Advisory

Covid-19, demography, and pension trends: complex interactions

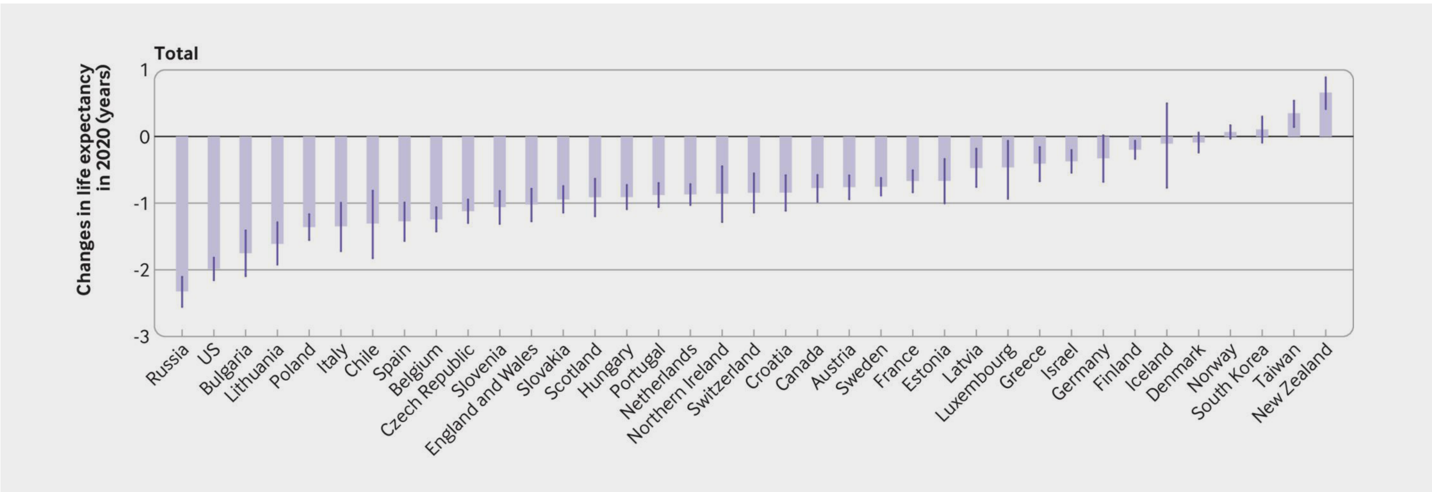
The aftereffects of the 2011 Great East Japan earthquake were numerous and included amongst others the reactor meltdowns of the Fukushima Daiichi nuclear power plant with dire consequences. One lesser-known repercussion was the shift of Honshu, Japan's main island, by 2.4 metres to the East, which has accelerated the Earth's rotation. Plate tectonics movements regularly trigger a shift of the island to the East, although usually at a much lower degree of 8cm per year on average.

In a parallel fashion, the COVID crisis has had significant consequences on pension funds' demography: some have been immediate; some are yet to be fully understood. However, they can be considered within the long-term demographic trends, shifting the balance of demography whereby baby boomers are either retired or about to be, with a lower population of active workers to sustain their retirement.

Immediate improvement in the solvency of pension funds

The immediate implications on pension liabilities have somewhat improved the solvency of pension funds. Pension liabilities have decreased slightly due to reduced longevity. The 2020 longevity of US men for example is estimated to have decreased by 2.27 years on average.[12] (Figure 1.1).

Figure 1.1 - Changes in life expectancy at birth associated with Covid-19 pandemic in 2020



Source: BMJ 2021;375:e066768

However, this **impact is somewhat mitigated** by the fact that:

- The pandemic has had a greater impact on poorer populations, that may not be covered by pension funds;
- The pandemic has had a larger effect on older populations, whose share of pension liabilities is often relatively small as the liability duration they trigger is usually shorter[13];
- Some increased uptake in early retirement has been observed due to the Pandemic: nearly two in five recent US retirees said they retired earlier than they had expected[14]. However, it remains to be seen whether this trend will continue: a study showed that only 16% of those currently working said they planned to retire earlier due to the pandemic.

12 BMJ 2021;375:e066768 - Effects of covid-19 pandemic on life expectancy and premature mortality in 2020: time series analysis in 37 countries
13 https://www.benefitnews.com/advisers/opinion/will-covid-19-affect-pension-funding-liabilities
14 https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2021/05/in-early-results-covid-19-appears-to-have-little-impact-on-retirement-preparation-and-withdrawals

So what is the magnitude of the reduction in liabilities? The increased mortality, mitigated by the factors explained above, should have an immediate impact on liabilities. In the UK for example, some estimates show that pension liabilities may be over-estimated by 1.5 to 3.5%[15].

In parallel, as shown by the pension fund update in article 4, pension assets have performed well during the pandemic. A combination of higher rates, good asset performance and lower liabilities mean that the short-term impact of the pandemic is not immediately negative.

Long-term consequences of COVID are still to be revealed.

Longevity – The long-term impact of COVID-19 on longevity is yet to be fully determined: better hygiene, more effective vaccines, or more means devoted to research for example could actually increase pension liabilities.

Inflation – The higher inflation that we are currently experiencing will also increase the cost of offering pensions. This will be critical especially for pension regimes where the link to inflation is formulaic such as the UK, or the US where the public plans usually include a *Cost of Living Adjustment* feature. In addition, sustained inflation will have a long-term impact on assets, both risky and hedging portfolios, which should be taken into account.

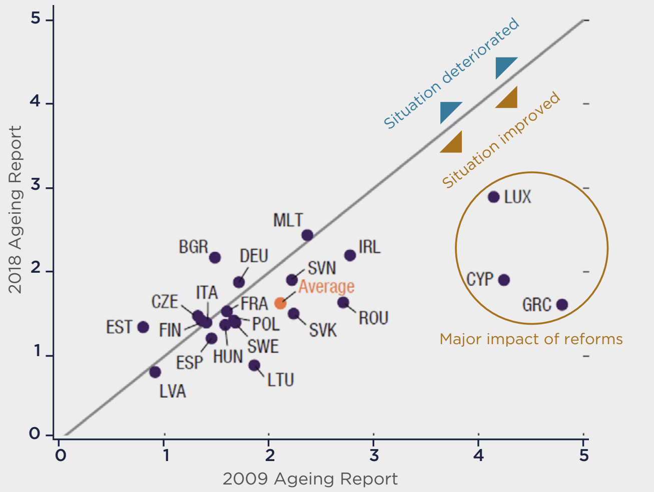
Plan contributions – the capacity for plan sponsors to make contributions depends on their health. Some sectors that have suffered due to the pandemic, such as the airline industry, are among those with the largest pension exposure. In the Amundi-CREATE 2021 survey, we see that 48% of pension funds answering the survey worry about the financial viability of their pension plan in the long run due to the net impact of COVID-19.

Broader demographic changes on the horizon, independent of COVID-19

Lastly, there are the long-term tectonic shifts that happen in our demography that have long-term and very significant impact on pension funds.

Be ready for political reform – By 2030, 65+ year-olds will make up more than 20% of the population in at least 34 countries.[16] Today in Europe, the average pension system deficit stands at around 2.5% of GDP and is projected to increase to 4% in the next three decades.[17] This may trigger a further wave of political reforms. In a study, the International Monetary Fund (IMF) estimates a Proportionality Measure (PM) that compares contributions made during working life and payments received at retirement. This is a gauge of pension fairness: if the ratio is higher than 1, the retiree will receive more than they contributed. The IMF estimates that this ratio was on average 2.0 in 2009 in Europe. Political reforms following the Great Financial Crisis improved this ratio significantly to 1.5 in 2018 (Figure 1.2), but political pressure pushed some governments to reduce or delay system changes and this ratio increased again to 1.8.

Figure 1.2 - Proportionality measure for cohort born in 1990



Source: 2009 and 2019 Ageing Reports; Eurostat; IMF staff calculations; Amundi

Brace for lower long-term growth and asset returns – Measuring the impact of demographic changes on expected return on assets is complex. In a 2015 paper (Aksoy et al.), researchers found that the decrease in working-age population and fertility alongside the increase in the proportion of retirees expected for the next 20 years would result in a strong decrease in trend output growth and significantly lower the real interest rate. They estimated that this drag on GDP growth in the 2010/2019 decade had been 1.33% in the US, 0.73% in the UK, 1.16% in France and 0.60% in Germany.

What can pension funds do against this backdrop of demographic change?

These significant changes, whether they are related to the immediate impact of the pandemic or to the long-term demographic forces that were already at play, will have a strong impact on the pension community.

In March 2021, the World Bank[18] looked back at the Great East Japan earthquake to see what lessons should be drawn from this catastrophe. Their three recommendations were:

- To plan: "Even though disasters will always be unexpected, if not unprecedented, planning for disasters has benefits both before and after they occur";
- To share: all parties should work in the same direction;
- To be iterative: revise the planning on an ongoing basis, taking into account new information.

These conclusions should resonate with the pensions industry and it is essential for pension funds to produce detailed plans, collaborate on an industry-wide basis and regularly update their assumptions.

15 Pension schemes could be overestimating pension liabilities by up to 3.5% following Covid-19, XPS Pensions Group, 22/03/21, https://www.xpsgroup.com/news-and-views/pension-schemes-could-be-overestimating-pension-liabilities-by-up-to-35-following-covid-19/
16 Population ageing : pension policies alone will not prevent the decline in the relative size of the labour force, Hervé Boulhol, Christian Geppert, OECD, 4/06/18
17 Rethinking pension systems in Europe for a post-Covid-19 world, Armand Fouejieu, Alvar Kangur, Samuel Rimero Martinez, Mauricio Soto, IMF, 2/10/21
18 Learning from Megadisasters: A Decade of Lessons from the Great East Japan Earthquake, Shoko Takemoto, Naho Shibuya, and Keiko Sakoda, 11/03/21

Jean-Xavier BOURRE
Senior OCIO Advisor at Amundi

Pension funding ratios: Plotting a steady course

The last quarter has been very volatile on the interest rate front, in particular the slopes of the main yield curves (US Treasury 10/30 flattened by some 20bps around the 15y tenor, Bund by 27bps and Gilts by 42bps[19]). The balance between the publication of surprising and deteriorating inflation data in most economies and financial conditions that remain very accommodative (due to only moderate changes in stance from major central banks) has fueled significant arbitrage along yield curves.

Consequently, funding ratios were virtually unchanged between June and October 2021 in the UK (55% of UK PF are now in surplus according to PPF[20]) and Germany, where they improved by some 1%, in the Netherlands (latest data available as of end September 2021) and the US. In all these jurisdictions, the funding ratio moved in a range wider than 2%.

Noticeably, the average funding in the Netherland reached the 110% level (110.3% end of September). This 110% level is the current threshold for the Policy Funding Ratio[21] of individual pension funds to be able to re-index pensions to inflation. The Dutch government has proposed to decrease this level to 105%, conditional on specific conditions linked to adherence to their pension fund reforms.

	31/12/2018	31/12/2019	31/12/2020	30/06/2021	31/07/2021	31/08/2021	30/09/2021	31/10/2021
Netherlands	103.6%	104.3%	100.2%	109.4%	107.6%	109.2%	110.3%	
UK	95.7%	99.2%	95.5%	105.8	103.5%	104.7%	106.4%	105.9%
US	86.10%	86.80%	87.90%	92.4%	92.4%	93.0%	91.7%	93.5%
German CTA	67.3%	67.9%	69.1%	73.9%				74.1%

Sources:
- UK data: Purple Book, PPF S179 funded status, for 31/12/18 until 31/10/21
- Netherlands data: Dnb from 31/12/18 to 30/09/21
- German CTA data: FactSet, based on average pension exposure of German corporates of EUROSTOXX 600 for 31/12/18 until 30/12/20. Amundi estimate from 30/06/21.
- US data: Aon Pension Risk Tracker as 31/10/21

19 Source : Amundi, Bloomberg
20 See https://www.ppf.co.uk/ppf-7800-index
21 Policy Funding Ratio : average of the last 12 months Funding Ratio

INVESTMENT OUTLOOK 2022

INVESTING IN THE GREAT TRANSFORMATION

Read the full article here

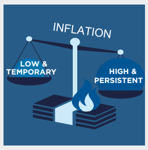
10 KEY MESSAGES FROM THE 2022 investment outlook

1. The road back to 70s narrative gains traction.
2. Central Banks (CB) hold the key to the cycle.
3. After an initial tiptoe into tapering, expect more, not less, monetary accommodation.
4. The cycle will extend further, but frenzied markets are no longer in sight.
5. The concept of EM as a block is definitely over.
6. Targeting real returns is the new horizon, beware of the nominal illusion.
7. Real rates will determine the fate of excessive equity valuations.
8. Resist the temptation to go long duration.
9. We will likely see some cracks relating to leverage issues come to the surface.
10. The green and social recovery will push towards ESG mainstreamisation.

From post pandemic euphoria to slowing economic momentum

From liberalism to government interventions, with a focus on ESG themes

From global value chain to self-independence



From low/temporary inflation, to stickier inflation

Central Banks, from old to new mandates

CROSS ASSET Investment Strategy

BASE AND ALTERNATIVE SCENARIOS AND RISKS

Upside
Inclusive and sustainable growth

15%

Central scenario
Bumpy road, regional divergences

Covid-19 becomes an endemic disease, with random contagion waves.

Growth catch-up in 2021-22 converges to trend in 2022-23. Soft patch in H1 2022 due to China's slowdown and accelerating inflation.

Persistent inflation pressures due to supply-side bottlenecks and to rising wage pressures.

Monetary policy asynchrony: Fed to taper, BoE could hike rates, ECB on recalibration mode, and PBoC on an easing bias. Rates to stay low for longer.

Fiscal policy: withdrawal of some accommodation, but support will be needed for the energy transition.

Climate change bites into growth and inflation by disrupting the commodity cycle and adding to stagflationary trends.

70%

Downside
Renewed slump towards stagnation

15%

CROSS ASSET Investment Strategy

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		After the Fed's taper update in late September, inflation expectations and bond yields gained strength and the reopening trade reasserted its relative performance. However, strong inflation data necessitates that investors protect their portfolios from rising prices and volatility from debt ceiling and tax hikes should also be kept in mind. While remaining overall neutral on equities, we believe investors should increase their focus on fundamentals as valuations remain high.
EQUITY PLATFORM	US value	+		The recent rise in core yields has been accompanied by escalating inflation. We believe value (financials, energy) is a strong way to inflation-proof portfolios, particularly in the case of quality companies that possess strong pricing power. The value vs. growth discount is high but long-term returns in this realm will be driven more by stock selection.
EQUITY PLATFORM	US growth	-		We think current valuations are inconsistent with expectations of high inflation and subsequently higher (real) rates, which could challenge excessive valuations. As we progress on this front, growth stocks that rely on low discount rates for their prices should experience volatility, thereby warranting a defensive stance.
EQUITY PLATFORM	Europe	=		Amid a spike in energy prices, economic recovery continues in Europe but valuations are extreme in some segments and are not justified by high inflation, which pressures companies to absorb costs, thereby affecting margins. However, amid the high valuation dispersion, investors should prioritise selection and explore value and quality stocks that can withstand price pressures through strong pricing power or a dominant market position beyond the current earning season.
EQUITY PLATFORM	Japan	=		Given that Japan is a more cyclical market, equities should remain supported by an earnings catch-up as new Covid cases recede and as the reopening continues. A weaker yen should further support this.
EQUITY PLATFORM	Emerging markets	=		We believe the case for selection is high in EM and it should no longer be seen as 'one block.' Looking ahead, normalisation of earnings and progress on the vaccination front paint an encouraging picture for EM, but there are some idiosyncratic risks. On China, some weakness in growth and potential regulatory measures make us cautious in the near term, but the long-term outlook is positive as the country embarks on more balanced and high-quality growth. We like countries such as Russia due to its strong exports, and India owing to its potential for domestic demand.
FIXED INCOME PLATFORM	US govies	-		Core yields have been rising after comments from the September FOMC meeting amid the Fed's tapering indications. But inflation remains elevated even as supply constraints persist. We believe USTs could be under pressure, but the risks of inflation derailing a recovery mean CBs may be unwilling to implement substantial tightening. As a result, we are cautious on duration but remain flexible. TIPS offer inflation-protected returns but there are valuation concerns.
FIXED INCOME PLATFORM	US IG corporate	=		Credit fundamentals are constructive but we are exploring the asset class through a highly selective lens that allows us to limit our beta and exposure to long duration debt. We are also watchful of the risks from rising core yields at the moment. Securitised credit and mortgages are attractive due to high consumer earnings and savings, but we are vigilant on housing markets amid the Fed's potential tapering.
FIXED INCOME PLATFORM	US HY corporate	=		We are moving towards a phase where market directionality will play a decreasing role in driving returns. Although the segment offers good carry and fundamentals are benign, we are increasingly relying on selection to separate the wheat from the chaff and avoid highly leveraged areas.
FIXED INCOME PLATFORM	European govies	-/=		Inflation is high amid supply bottlenecks and pressures from the energy situation, which is collectively reflected in rising yields. While the ECB indicated some slowing in asset buying, we believe it will strive to maintain accommodative financial conditions. Thus, we remain defensive and agile on core and semi-core European government bonds. On periphery debt, however, we are positive due to the recovery and support from the Next Gen EU fund, but are monitoring political risks.
FIXED INCOME PLATFORM	Euro IG corporate	=/+		Fundamentals continue to improve, albeit at a slightly slower pace, and liquidity remains high. However, we increase the selectivity in our portfolios to look for companies that can pass on the increase in costs to consumers. We like shorter maturity debt and BBB-rated names, but avoid higher rated names that may engage in unproductive M&A or add debt.
FIXED INCOME PLATFORM	Euro HY corporate	=		We believe this is not a time for structural derisking but are careful of longer-dated debt and prefer playing the spread compression card. Subordinated financial debt presents a strong theme across credit with its attractive yield, but overall we maintain a balance between higher yield and quality.
FIXED INCOME PLATFORM	EM bonds HC	=/+		Improving current account balances and the EM growth differential vs. DM are positives. We continue to favour HC debt and maintain our bias towards HY vs. IG in countries benefitting from strong fundamentals and higher commodity prices.
FIXED INCOME PLATFORM	EM bonds LC	=		A strengthening dollar in the near term and potential tightening in the developed world are a natural challenge for LC, underscoring the need to be selective. We focus on countries such as Russia, where monetary tightening is almost over. In Asia, the PBoC will strive to avoid any spillover to other parts of the economy.
OTHER	Commodities			While natural gas prices have increased due to demand/supply imbalances in Europe and Asia, they are not out of control. In the long run, the world is expected to be in net surplus. OPEC should increase oil production in order to avoid a hit to global demand. However, gold could see some volatility (Fed policy normalisation) but is still a decent portfolio diversifier.
OTHER	Currencies			Monetary policy divergences and slowing global growth should be positive for the USD (high quality carry) vs. low yielding FX such as the EUR, CHF and JPY. However, relative to high yielding cyclical currencies, the USD should stabilise. Long term, high US deficits and debt are likely to weigh on the greenback.

--- -- - | = | + ++ +++

Negative view | Neutral | Positive view

▼ Downgrade vs previous mont
▲ Upgraded vs previous month

Source: Amundi, as of 26 October 2021, 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.

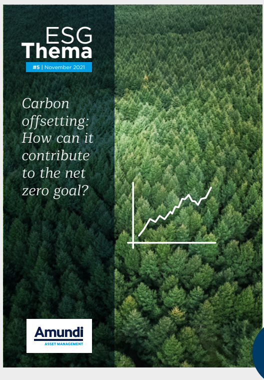
IG = investment grade corporate bonds, HY = high yield corporate; EM bonds HC/LC = EM bonds hard currency/local currency. WTI = West Texas Intermediate. QE = quantitative easing.

To go further: The Amundi Research Center

Research Center

Amundi's independent research platform boasts 126 international experts who support both domestic and international investment teams. Covering the main aspects of investment research, our in-house experts seek to anticipate and innovate to the benefit of both investment teams and clients alike. For more information on the below documents and to download them please browse on our website: **research-center.amundi.com**

ESG Thema



Shifts & Narratives

Thematic Papers