European Pensions

June 2021

Ask the industry:

Inflation concerns

How can pension schemes protect their investments from rising inflation?

Pension costs:

Fees and taxation

What can be done to protect members' savings from being chipped away by fees?

Defined benefit schemes:

Funding levels

Funding levels are on a high; what does this mean for DB scheme investment strategies?

Pension contributions:

Impacts of Covid-19

How were pension contributions impacted by the Covid-19 pandemic?

A new dawn

What will be the impact of Norway's recent pension reforms?

www.europeanpensions.net

Plus:

Currency investing focus

Equity factor investing roundtable

Sustainability guide

See p18 for an interview with board member Evalinde Eelens

Don't go breaking my... pension

I recently watched the Elton John biopic, *Rocketman*, about the singer's life from childhood, through to his rise to fame and his self-confessed struggle with addiction.

As a child of the 90s, I missed the memo on John spiralling out of control in the late 70s, only knowing him for his classics, such as *Rocketman*, *Tiny Dancer*, and *I'm Still Standing*, which have been known to get me on the dance floor at the European Pensions Awards on several occasions.

Nor had I quite realised how quickly he became so rich, which was a huge factor in enabling his addictions. Although it was a film about John's life, it was also a lesson in the huge responsibility that money brings. For John, on a personal level, he was irresponsible with his money and ended up down a wayward path.

Still to this day he admits to a spending addiction, having once reportedly spent £40 million in 20 months, but it is his money to be irresponsible with. Being responsible with money is, of course, much more important when the money you're in possession of is not your own.

Pension funds and providers, for example, have one of the biggest monetary responsibilities, having been entrusted with looking after the money people will live off in old age.

In this issue of *European Pensions*, we explore the theme of money from several perspectives for pension funds. Our feature on defined benefit (DB) schemes [*page 60*] looks at the miraculous recovery DB funding levels have made over the past year and the investment strategies schemes have adopted to get to this position.

We also consider the impact of various fees and tax policies that pension funds and members have to bear [*page 57*], which can have a significant detrimental effect on the value of a pension pot at retirement. As part of its responsibility, the industry must also educate members on being more sensible with their own savings.

To that end, the Swedish Pensions Agency recently reduced its benchmark low fee for global equity index funds to 0.2 per cent. The previous benchmark was set at 0.4 per cent but the change was made as the agency wants to increase awareness amongst savers that fees on selected funds can have a negative effect on value development.

This leads onto our guide on sustainability [*page 31*], as being a responsible investor is becoming an imperative part of a pension fund's monetary responsibilities. It is widely agreed now that not investing sustainably risks future returns. Our guide covers the new EU Sustainable Finance Disclosure Regulation, how to give all investors voting power within pooled funds and why less carbon means stronger growth for the global economy. Enjoy!

Natalie Tuck, Editor

Editor in Chief
Francesca Fabrizi
+44 20 7562 2409

Editor
Natalie Tuck
+44 20 7562 2407

Associate Editor
Laura Blows
+44 20 7562 2408

News Editor
Jack Gray
+44 20 7562 2437

Reporters
Sophie Smith
+44 20 7562 2425

Duncan Ferris
+44 20 7562 4380

Commercial
John Woods
+44 20 7562 2421

Camilla Capece
+44 20 7562 2438

Lucie Fisher
+44 207 562 4382

Design & Production
Matleena Lilja
+44 20 7562 2403

Accounts
Marilou Tait

Circulation
perspectivesubs@dynamail.co.uk
+ 44 1635 588 861

Management
John Woods, Managing Director
Mark Evans, Publishing Director

Subscription rates:
£198 or €299 per annum

www.europeanpensions.net

6th floor, 3 London Wall Buildings,
London, EC2M 5PD

ISSN 1753-5859

European Pensions has agreements with several associations to reach their membership. For details contact john.woods@europeanpensions.net

APAPR

Publisher Member

Contents

June 2021

General features

Country spotlight

Focus

Contents

Sustainability guide

Interviews

Regulars

EIOPA launches two consultations on regulation of IORPs

IT IS ASSESSING RISK ASSESSMENT SUPERVISION AND COSTS

Written by: Natalie Tuck and Jack Gray

The European Insurance and Occupational Pensions Authority (EIOPA) has launched two consultations regarding Institutions for Occupational Retirement Provisions (IORPs).

The first is seeking views on proposals surrounding the supervision of risk assessments by IORPs providing defined contribution (DC) pension schemes.

EIOPA noted that, due to the ongoing shift from defined benefit (DB) to DC pension provision, a "risk sensitive" supervisory approach to DC risk management was needed, to ensure that risks DC IORPs, members and beneficiaries are subject to, are "appropriately managed and supervised".

Its proposals focus on two areas of DC risk management. Firstly, it focuses on the use of quantitative elements in operational risk management, which would supplement the guidance in the existing opinion on the supervision of the management of operational risks faced by IORPs.
Secondly, the use of projections of future retirement income in assessing long-term risks from the perspective of members and beneficiaries, also in interaction with the establishment of their risk tolerance and the design of investment strategies.

The second consultation sets out proposals on the supervisory reporting of costs and charges of IORPs.

EIOPA stated that, as costs and charges can have a negative impact on future retirement income and sponsor contributions, a transparent and comprehensive view of costs and charges was "essential".

The consultation outlines expectations on the supervisory reporting of costs and charges of IORPs using a proportional and risk-based approach.

It also provides a "generic classification" of all costs to be reported to national supervisors, including templates, both for supervisors to collect cost information from IORPs and to assist IORPs to collect cost information from investment managers.

Additionally, principles are provided for the compilation of the cost information, including the look-through principle, meaning that direct investment costs will have to be reported alongside indirect costs at an investment manager level.

EIOPA continued: "The draft opinion also provides guidance on the supervisory use of the cost data. National supervisors are expected to assess the efficiency of IORPs, affordability for sponsors and the value for money offered to members and beneficiaries, not considering the costs in isolation, but in conjunction with risk and return characteristics.

"The results of such benchmarking exercises should feed into the supervisory review process and the regular dialogue with the IORPs' management boards." EIOPA stated that stakeholders have until 22 July 2021 to respond to the consultations and it expects to publish its final response in Q4 2021.

In other news, an EIOPA report found that unit-linked personal pension products (PPPs) generated a higher return, but were more volatile, than profit participation PPPs between 2015 and 2019.

Its *2021 Cost and Past Performance Report* analysed PPPs sold by insurance undertakings. The product categories considered were the same as for insurance-based investment products (IBIPs) – PPPs similar to unit-linked (PPP-UL), those similar to profit participation (PPP-PP) and PPPs similar to hybrid (PPP-Hybrid), despite the fact that in some markets PPPs are not formally IBIPs.

Based on the information provided by 69 insurance undertakings from 14 member states, more than 210 PPPs have been analysed: 125 PPP-UL, 53 PPP-PP and 38 PPP-Hybrid, accounting for ca. 1.4 million of contracts sold and ca. €27bn gross written premium (GWP) during 2019.

"As expected, the trends in the net return of personal pension products are similar to the ones observed for IBIPs, hence higher average yearly annual return but also higher volatility for PPP-ULs in comparison with PPP-PPs. The net return achieved in 2019 was also the highest for the period 2015-2019," it stated.

Later in the month, PensionsEurope called on the European Commission to focus more on multi-pillar pension systems, in response to its *Green Paper on Ageing: Demographic change in Europe*. Although it welcomed the paper, as it believes it is a good starting point to launch a debate on the main impacts of the demographic transformations in Europe, it highlighted a lack of focus on the role of multi-pillar pension systems.

"National supervisors are expected to assess the efficiency of IORPs, affordability for sponsors and the value for money offered to members"

"As representative of national associations of pension funds and similar institutions for workplace and other funded pensions, PensionsEurope believes one of the main needs people have is to enjoy an adequate standard of living in retirement, which implies having good pensions.

"We think more needs to be done at a European Union and national levels and with the involvement of the social partners and all interested stakeholders to ensure that all people will enjoy adequate living standards in old age," it responded.

Therefore, it said the paper should reflect more on the role that workplace pensions can play, such as providing additional retirement income, keeping pension systems sustainable in the long term, whilst contributing to economic growth in Europe.

"The green paper, the debate that will follow, and the measures that eventually will be considered by the European Commission, should include policies and initiatives aimed at facilitating and encouraging participation in workplace pension schemes. Workplace pensions are essential for the adequacy and sustainability of our pension systems. PensionsEurope and its members are strong supporters of multi-pillar pension systems able to provide adequate and sustainable pensions to people in Europe," it said.

Therefore, PensionsEurope said the paper should recognise the importance of having multi-pillar pension systems and the commission should discuss, and decide, which actions are needed to further support their development.

News in brief

■ The average **Dutch** coverage ratio increased to 109 per cent from 108 per cent in April, according to Aon's latest analysis. Its Pension Thermometer also revealed that the policy funding ratio increased to 98 per cent. This funding ratio is above the adjusted temporary statutory minimum requirement of 90 per cent. Aon said the increases over the past three months mean that most pension funds are "out of harm's way" and won't have to make cuts.

■ The **Swedish** Pensions Agency has produced a recommended benchmark that sets 0.2 per cent as a low annual fee for global equity index funds in the Swedish fund market. The previous benchmark was set at 0.4 per cent, but the change was made as the agency wants to increase awareness amongst savers that fees on selected funds can have a negative effect on value development.

■ The **Danish** pensions industry has invested DKK 600bn in unlisted assets, according to Insurance and Pension Denmark. This includes wind farms, non-listed companies, properties and ports. The figure is equal to one-fifth of the pension industry's total investments.

■ **Norway's** Norges Bank Investment Management (NBIM) has signed an agreement to acquire a 50 per cent stake in a Dutch offshore wind farm for €1,375m. The agreement will see NBIM acquire the stake in Borssele 1 & 2 from Ørsted A/S, and the two will be co-owners, with Ørsted A/S keeping the other 50 per cent stake. No external debt financing will be involved.

Irish govt completes transposition of IORP II Directive over two years late

THE IRISH GOVERNMENT COMPLETED THE TRANSPOSITION OF EU IORP II REGULATIONS FOLLOWING SEVERAL DELAYS

Written by: Natalie Tuck and Jack Gray

Picture source: Robert Keane / Shutterstock.com

The Irish government has completed the transposition of the European Union's IORP II Directive, over two years later than the January 2019 deadline.

In a statement on the Department of Social Protection's website, it was revealed that on 27 April, the Minister for Social Protection, Heather Humphreys T.D., formally signed the European Union (Occupational Pension Schemes) Regulations 2021, which, amongst other things, amends the Pensions Act 1990 [No. 25 of 1990] to transpose requirements of Directive (EU) 2016/2341 [OJ No. L 354, 23.12.2016, p.37] (IORP II Directive) into Irish law.

While many of the provisions of the directive had already been transposed into Irish law, regulations under the European Communities Act 1972 were necessary to transpose requirements of the directive not provided for in Irish law.

The over-arching objective of the IORP II Directive, which is a revision of the original IORP Directive of 2003, is to facilitate the development of occupational retirement savings in the European Union. The new regulations will apply to all schemes and trust Retirement Annuity Contracts (RACs), including small schemes and one-member arrangements, where possible.

Guidance on the new regulations has been a contentious issue for the Irish pensions industry, with the Pensions Regulator, Brendan Kennedy, previously stating that there would be no guidance available until after the transposition of the directive. Despite this, the Pensions Authority has on several occasions expressed its disappointment at the lack of preparation by many schemes.

However, following the transposition of the directive, the Pensions Authority has published an information note for trustees, outlining how it plans to oversee compliance with IORP II regulations.

The information note includes a summary of key provisions under the amended Pensions Act 1990, including governance requirements, risk management, fit and proper trustee requirements, and expectations on written policies.

For master trusts, the Pensions Authority's immediate focus will be on direct engagement to assess their progress towards compliance with all the obligations detailed in the regulations, and will include a compliance review with the authority's defined contribution master trust requirements.

Master trusts will be expected to be fully compliant with the IORP II regulations from 1 July 2022.

One-member pension arrangements established on or after 22 April 2021 will be expected to be fully compliant from 1 July 2022.

Existing one-member arrangements will have until 22 April 2026 to be fully compliant, other than with the investment and borrowing rules that apply to investments made, and borrowings entered into after regulations come into operation.

For all other schemes and trust RACs, the authority will expect to see evidence of a plan with specified timelines and progress milestones to achieve compliance.

Any new scheme that is established after 1 July 2022 will be expected to be fully compliant from its introduction, while existing schemes and trust RACs are expected to be fully compliant from the beginning of 2023.

Dutch pension legislation delayed to 2023; transition guidance in development

MINISTER KOOLMEES CONFIRMED THE DELAYED DATE IN A LETTER TO PARLIAMENT

Written by: Sophie Smith

The Dutch Minister for Social Affairs and Employment, Wouter Koolmees, has confirmed in a letter to parliament that the Future of Pensions Act will be introduced by 1 January 2023, a year later than expected.

The reforms have been hit with delays since the collapse of the Dutch government, with the minister's plans to submit the reforms by this summer described as "not realistic".

Despite these delays, the Dutch Pension Federation has emphasised the importance of continuing to strive for the January 2026 implementation date.

It also clarified, however, that there must be sufficient time for careful implementation, arguing that a timely and smooth start to the running of the process between social partners and pension funds is important.

"It is also important that supervisors carry out an integrated assessment, within clear decision periods that are in balance with the time that pension funds have for implementation," it stated.

In light of this, The Labour Foundation, the Pension Federation, and the Dutch Association of Insurers will be working together to develop guidance to aid all involved parties in the transition to the more modern style pension system.

The Ministry of Social Affairs and Employment will also be working closely on this project, with the online platform expected to be launched in the summer of 2021.

The Pensions Federation emphasised that the transition to a more modern pension system will be "radical, complex and extensive", with many parties playing a role in the decision-making process.

It also noted that there are pension funds working towards switching to the new system on 1 January 2023, arguing that the legislation and subordinate regulations need to be known "in good time" by 2022.

Indeed, the minister confirmed in the letter that he expects to be able to send the legislation to the Lower House in early 2022, with the parties involved expected to look into what is needed to facilitate the transition from 2023 onwards.

The transitional financial assessment framework (FTK) is also part of the delayed legislation and as such will also be subject to the later date, although it will be no later than 1 January 2023.

The minister also confirmed that the temporary scheme, in which pension funds do not have to make cuts if the funding ratio is above 90 per cent, has been extended by a further year to 2022.

Alongside this news, the Pension Federation has emphasised the need to implement the Pension Agreement unchanged, arguing that this will allow workers in the Netherlands to accrue an adequate pension, as well as providing financial protections for their surviving relatives.

It stated: "For the Pension Federation, innovation while preserving the good is paramount. The renovation must run smoothly and be completed on time. No load-bearing walls must be broken down and no cosmetic extras added that make the system unnecessarily more complex. After all: the simpler a new system, the more efficient the implementation."

Considering this, it urged the forthcoming cabinet to focus fully on the implementation of the Pension Agreement and maintaining the ambition level for all participants, warning that any austerity will lead to a "false start" for the new structure. It also called for the cabinet to provide an adequate survivor's pension system, and to organise for the self-employed to access suitable collective pension accrual.

German Bundestag passes pension scheme employer support amendment

THE GERMAN FEDERAL PARLIAMENT IS AIMING TO IMPROVE THE PENSION SCHEME SUPPORT FRAMEWORK

Written by: Natalie Tuck and Jack Gray

Picture source: Wirestock Creators / Shutterstock.com

The German federal parliament, Bundestag, has passed an amendment to the Insurance Supervision Act to improve the framework for sponsoring employers to financially support their pension schemes.

The amendment will also allow many pension funds to restructure parts of their portfolio in a way that better suits their interests.

Although sponsoring employers were already able to financially support pension funds, companies could run into difficulties with pension funds that have a varied or unusual sponsoring structure.

The new amendment aims to make this process easier and the regulations are expected to come into force on 1 January 2022.

Arbeitsgemeinschaft für Betriebliche Altersversorgung (ABA) Working Group for Company Pensions chairman, Dr. Georg Thurnes, noted that, amid the ongoing low-interest environment, this change was "very welcome".

He continued: "This will create an instrument for the future which, in many cases, can prevent comprehensive reductions in benefits by a pension fund through more precisely tailored support services from sponsoring companies.

"In view of the ongoing low-interest rate situation, the legislature has created some regulations in recent years, so that sponsoring companies can financially support pension funds to strengthen their risk-bearing capacity.

"A number of sponsoring companies have already made use of these regulations. Practice has shown, however, that support services from sponsoring companies run into difficulties with pension funds with a heterogeneous sponsoring structure.

"The amendment will improve the framework conditions for making support payments to certain pension funds.

"In many cases, this means that the sponsoring companies of a pension fund have the opportunity, in the event of extraordinary needs, to financially strengthen the sub-fund of the pension fund for which they are regularly liable."

ABA stated that preparatory considerations and measures could be started this year, with ABA Pension Fund Association head, Jürgen Rings, stating that ABA would support its members in the implementations and use of the new regulations.

In other news, German companies listed on the DAX 30 had pension liabilities of €407bn at the end of 2020, up from €389.9bn at the end of 2019, according to Mercer.

Over the same period, pension assets as reported in IFRS financial statements increased from €258.6bn to approximately €266bn. The coverage ratio of pension schemes is around 65 per cent and has fallen only slightly compared to the previous year (66 per cent).

Mercer said DAX 30 company pension schemes have performed significantly better than expected.

The analysis by Mercer is based on the annual reports of the DAX 30 companies.

Mercer said that some of the changes are due to the change in the composition of the DAX 30.

For example, in 2020 Lufthansa and Wirecard left whilst Deutsche Wohnen and Delivery Hero were re-introduced.

"Due to the extreme interest rate fluctuations at the beginning of the coronavirus pandemic, the interest rate level at the end of the year was uncertain," Mercer Germany chief actuary, Thomas Hagemann, said.

Romanian mandatory private pension assets increase by a third

THE ROMANIAN FINANCIAL SUPERVISORY AUTHORITY REVEALED THAT MANDATORY PRIVATE PENSION FUND ASSETS HAVE EXCEEDED RON 80BN

Written by: Jack Gray

Mandatory private pension funds in Romania registered a one-third year-on-year increase in total assets at the end of Q1 2021, the Romanian Financial Supervisory Authority (ASF) has revealed.

The increase saw total assets in the sector exceed RON 80bn.

Commenting on the figures, ASF president, Micu Marcu, said: "Mandatory private pension funds continue to have a solid evolution, a remarkable thing, considering that we are going through a less favourable period from an economic point of view.

"The sustained growth rate confirms the stability and resilience of the private pension system, as well as its ability to develop and generate long-term benefits for participants."

Marcu noted, however, that the "vast majority" of participants were randomly allocated, and highlighted the potential merits of more accurate data.

The ASF added that the private pension market had evolved "positively" since its introduction and it had managed to overcome recent market volatility.

At the end of last year, the Romanian mandatory private pension market had the largest share of GDP in non-banking financial markets (around 7.5 per cent).

Finnish goal retirement age rises by almost 2 years in a decade

THE ONE YEAR AND 11 MONTH INCREASE IN THE AVERAGE EXPECTED RETIREMENT AGE AMONGST FINNS WAS PRIMARILY ATTRIBUTED TO LONGER WORKING LIVES

Written by: Natalie Tuck

The average intended retirement age in Finland has increased by almost two years over a 10-year period, according to the Finnish Centre for Pensions.

The analysis found that the intended retirement age in 2018 was 64 years and seven months, compared to 62 years and eight months in 2008. ETK economist, Satu Nivalainen, who has studied retirement intentions, says the change is significant.

Nivalainen believes the change in retirement intentions indicates that wage earners have largely accepted the extending of working lives. Their intended retirement age has risen at the same pace as the retirement age for the old-age pension. In practice, raising the old-age retirement age by one year means the intended retirement age will also rise by one year.

The new research also acknowledges the success of the 2017 pension reform. The aim of the reform was to extend working lives and postpone retirement. Studies show that wage earners' retirement intentions greatly predict the retirement behaviour of future retirees.

Of the workers that took part in Nivalainen's study, every third intended to retire at age 65. Every fifth intend to retire at age 66 at the earliest.

"Sixty-five years seems to mark a watershed. Nearly every third intend to retire before the age of 64, and every fifth at age 64," Nivalainen said.

News in brief

■ The **New York State Pension Fund** has invested more than USD 6bn in renewables and companies working to address climate change, it has revealed. The move follows a USD 4.1bn divestment by the city's pension fund from oil and gas earlier in 2021. Trustees of the pension fund had previously approved measures to shift investment away from fossil fuels and towards climate change solutions. Make My Money Matter CEO, Tony Burdon, praised the fund for "setting the bar high".

■The **Australian** Council of Superannuation Investors has said it will be tightening its climate change policy and could recommend voting against company directors that are not moving fast enough to meet Paris goals. As reported by *Reuters*, the association encouraged companies to adopt shareholder resolutions that call for annual emissions disclosures, emission reduction strategies and non-binding votes on corporate climate plans. It also urged companies to align their strategy to the Paris Agreement and net zero by 2050.

■ **Nigeria** has increased the capital requirement for pension managers, as it looks to direct the sector to target untapped opportunities in small businesses. Three Nigerian pension manager firms are in discussions to merge by next year, according to *Reuters*, to meet the new capital requirement of NGN 5bn. Pension funds in the country currently operate with NGN 1bn in capital. As of March 2021, Nigerian pension funds were worth approximately NGN 12.3trn, up from NGN 10.5trn in 2019. Fund growth slowed in 2020 due to Covid-19.

Chile allows further early private pension withdrawals

FOR THE THIRD TIME SINCE THE BEGINNING OF THE PANDEMIC, CHILEAN LAWMAKERS HAVE APPROVED THE EARLY WITHDRAWAL OF PENSIONS

Written by: Jack Gray

Lawmakers in Chile have approved legislation that will allow savers to withdraw up to 10 per cent of their pensions early, to help people cope with the financial strain caused by the Covid-19 pandemic.

This is the third time that Chileans have been allowed to access their retirement savings since the onset of the pandemic.

Savers in Chile were also allowed to withdraw up to 10 per cent of their private pensions in both previous instances, with around USD 20bn withdrawn during the first round of withdrawals and approximately USD 15bn taken out in the second.

Citizens are able to take money from the country's largest private pension system, Pension Fund Administrators.

Prior to the bill's approval, Chilean president, Sebastian Pinera, took it to the Constitutional Court, questioning the bill's legality.

He asked the court to review the bill, prompting protests from Chileans across the country.

In response to the passage of the law, Chile's central bank announced measures to soften market volatility, in what it said were necessary steps to smooth what is expected to be a significant drawdown from Pension Fund Administrators.

OTPP returns 8.6% in 2020

THE PENSION FUND REPORTED A CA$13.8BN INCREASE IN ASSETS

Written by: Jack Gray

Canada's Ontario Teachers' Pension Plan (OTPP) had a total fund net return of 8.6 per cent in 2020, its annual report has revealed.

Net assets increased by CAD 13.8bn year-on-year to CAD 221.2bn, as of 31 December 2020, while income from investments totalled CAD 18bn.

As of 1 January 2021, the scheme was fully funded for the eigth year in a row.

The annual report revealed a preliminary surplus of CAD 8.5bn and a funding ratio of 103 per cent.

As at 31 December 2020, Ontario Teachers' has had an annualised total-fund net return of 9.6 per cent since inception. The five- and 10-year net returns were 7 per cent and 9.3 per cent, respectively.

Commenting on the report, OTPP chief executive officer and president, Jo Taylor, said: "Our portfolio proved to be very resilient during a turbulent year. Through the headwinds of a global pandemic and volatile investment landscape, we delivered strong financial results and high service levels for our members.

"Our ability to navigate the many challenges posed in 2020 was anchored around the skill, agility and application of our team."

Diary dates 2021

The latest events occurring across the European pensions market

PLSA ESG CONFERENCE 2021
30 June- 2 July 2021
Online
This new conference will bring together the whole of the £2 trillion UK pensions investment chain across an online three-day programme. The timetable will include keynote speeches, educational sessions, topic deep dives and quick-fire updates, aiming to cover all angles of environmental, social and governance. Speakers will include Make My Money Matter co-founder, Richard Curtis, alongside TV chef and sustainability expert, Hugh Fearnley-Whittingstall.
plsa.co.uk/events/esg-conference

PENSIONS AGE AWARDS 2021
15 July 2021
London Marriott Hotel, Grosvenor Sq.
The Pensions Age Awards, which are now in their eighth year, aim to reward both the pension schemes and the pension providers across the UK that have proved themselves worthy of recognition in these increasingly challenging economic times. The awards are open to any UK pension scheme or provider firm that serves pension schemes in the UK. Two new categories have also been added this year, including the Pensions Age thought-leadership award.
pensionsage.com/awards/

EUROPEAN PENSION AWARDS 2021
20 October 2021
London Marriott Hotel, Grosvenor Sq.
Now celebrating their 14th successful year, the European Pensions Awards were launched to give recognition to and honour the investment firms, consultancies and pension providers across Europe that have set the professional standards in order to best serve European pension funds over the past year. The awards are free to enter and open to any pension fund or firm that serves European pension funds, with a deadline for entries of 24 June 2021.
europeanpensions.net/awards/

Not to miss...

WORLD PENSION ALLIANCE CONFERENCE
2-3 June 2021
Online
worldpensionalliance.org/events

IAPF BENEFITS CONFERENCE WEEK
19-21 October
Online
iapf.ie/events

PMI: DC AND MASTER TRUST SYMPOSIUM
7-8 July 2021
Online
pensions-pmi.org.uk/events

IRISH PENSIONS AWARDS 2021
18 November
5* Shelbourne Hotel Dublin
europeanpensions.net/irishawards

People on the move...

The latest news and moves from people within the European pensions industry

If you have any appointments to announce please contact natalie.tuck@europeanpensions.net

CARL PETTERSSON

The board of directors of Finland's Elo Mutual Pension Insurance Company has appointed Carl Pettersson as the company's new CEO. Pettersson, who will take up his position in autumn 2021, joins from Veritas Pension Insurance, where he is currently president and CEO, a role he has held since 2017. He has also previously worked for Aktia Bank. The board stated that he has the "experience and know-how" to lead the group.

EMMA DOUGLAS

Aviva has named Emma Douglas as managing director, workplace savings. In her new role, Douglas will report to Aviva managing director, UK savings and retirement, Rob Barker, who was appointed last month. She brings over 20 years' experience to the role, having held roles with both Mercer and BlackRock, and joins the team after a seven-year stint with Legal & General Investment Management.

RASMUS CEDERHOLM

AP Pension has promoted Rasmus Cederholm to investment director, following the departure of Ralf Magnussen to Nykredit Asset Management. Cederholm has been share manager at AP Pension since 2017. AP Pension CEO, Bo Normann Rasmussen, also noted Cederholm's "extensive experience" in asset management, stating that he has shown that he has the abilities AP Pension is looking for in a manager.

SARAH SMART

The Department for Work and Pensions has confirmed the appointment of Sarah Smart as the chair of The Pensions Regulator in the UK. Smart has served as interim chair since 1 April 2021, and is an experienced non-executive director and independent trustee, as well as a qualified accountant. Her appointment was also previously endorsed by the Work and Pensions Committee, after conflict of interest concerns were assuaged at a hearing in April.

JAMES WRIGHT

Northern Trust has appointed James Wright as head of its Institutional Investor Group (IIG) for Europe, the Middle East and Africa (EMEA). Responsible for driving the strategic direction and growth of the group across the region, Wright assumes the role having previously been head of IIG UK, Middle East and Africa. He has more than 30 years' experience in the asset servicing industry, and has held senior leadership roles at JP Morgan.

Picture by: Philippe Jolivel, Banque de France

PATRICK MONTAGNER
The European Insurance and Occupational Pensions Authority has re-elected Patrick Montagner to its management board. The Board of Supervisors made the decision to re-elect him to the management board for another term of two and a half years, following his initial appointment to the board in January 2019. He is also first deputy secretary general at the Autorité de Contrôle Prudentiel et de Résolution (ACPR).

MINNA HAKKARAINEN
Ilmarinen has announced the appointment of Minna Hakkarainen as insurance director for insurance and pension services. In her new role, she will be responsible for the services department, serving as the deputy line director. Hakkarainen also worked with Ilmarinen prior to this, having been based with the group since 2002, holding a number of roles, including process manager and customer service director.

KRISTINA ILAR
BNP Paribas Asset Management (BNPP AM) has appointed Kristina Ilar as a client relationship manager in its Stockholm office. The new role will see Ilar focus on developing BNPP AM's client base and strengthening relationships with existing clients. Prior to this, she was an executive director at UBS Asset Management, heading the Stockholm-based client coverage team, with direct responsibility for institutional clients in the region.

BARONESS ROS ALTMANN
Cushon has announced the appointment of Baroness Ros Altmann to its advisory board. The role will see Altmann provide strategic input on Cushon's proposition and product development, with her expertise expected to be "crucial" in the group's work. Altmann, who was previously the UK's Minister for Pensions from 2015 to 2016, is also a member of the House of Lords.

JUOKO PÖLÖNEN
The Finnish Pension Alliance (Tela) has appointed Ilmarinen CEO, Juoko Pölönen, as chairman of its board of directors. Pölönen was elected to the role at the group's annual general meeting, which also saw the CEO of Varma, Riso Murto, appointed as the first vice chairman, Keva CEO, Timo Kietäväinen, named second vice chairman, whilst Eläkekassa Verso managing director, Pasi Strömberg, was elected as third vice chairman.

CHRISTOFFER JÖNSSON
The board of Folksam LO Fondförsäkring AB (Folksam LO Pension) has appointed Christoffer Jönsson as CEO. Jönsson has been CEO of Bantorget Förvaltning since 2017, an investment company owned by LO and vice chairman of Folksam LO Pension's Board. His appointment follows the departure of Mia Liblik, who will instead drive the development of Folksam Life's occupational pension business.

European Pensions
AWARDS 2020

ETF Provider of the Year 2020

Amundi

European Pensions
AWARDS 2020
WINNER
ETF Provider of the Year

Exchange traded funds (ETFs) are gaining ground as a useful investment tool among pension funds. This category aims to recognise those providers that have stayed ahead of the market to offer ETFs to pension funds and tailored their offerings to pension fund demands.

The judges praised this year's winner for placing innovation and cost-efficiency at the core of its product development, to the benefit of its clients. Congratulations go to Amundi ETF, the ETF Provider of the Year!

Amundi ETF has been a pioneer of the ETF market in Europe, amassing assets under management globally of €61.7 billion by the end of 2020[1], confirming its position as a top-five ETF provider (by AUM) in the European market. With global net inflows of €8 billion in 2020[2], Amundi ETF had a record year and ranks among the top three ETF providers in Europe (by net flows).

Its ETF range centres on two key pillars: cost efficiency and innovation. With the expansion of the Amundi ETF product range in 2019 came the launch of the Prime ETFs, Europe's cheapest core ETF range offering both equity and fixed-income exposures. A success story of 2020 the Prime ETF range reached €2 billion AUM in only 18 months. Also in 2020, three further products across equity and fixed income joined this line-up, confirming the Amundi commitment to listening to clients and developing solutions to match their needs.

Amundi's leadership in the transition towards environmental, social and governance (ESG) investing goes back to its foundations. As an ETF provider Amundi recognizes the important role that passive managers play in encouraging widespread ESG adoption and is committed to making sustainable investing accessible to ETF investors.

Given the importance of aligning sustainable investments to individual objectives, Amundi extended its range of sustainable ETFs in 2020. The new additions to the range included eight equity ESG ETFs, reflecting the different reasons for investors' adoption of ESG. These additions were followed by the Amundi MSCI Emerging ESG Leaders UCITS ETF, launched with an initial investment from Finland's largest pension insurance company, Ilmarinen.

In addition, Amundi also expanded its climate range as one of the first asset managers to launch ETFs tracking the EU Paris-Aligned Benchmarks (PAB). The three new climate ETFs are designed to support the achievement of the objectives of the Paris Agreement in reducing global warming to below 2 degrees Celsius above pre-industrial levels. These sustainability-linked products were developed in line with the focus to offer investors simple, easy-to-use tools to help them implement their ESG and climate strategies.

Furthermore, Amundi takes its fiduciary obligations in terms of stewardship very seriously. Assets managed through index-tracking qualify for the same shareholder rights as actively managed holdings and the Amundi ETF range is part of the group's well regarded engagement programme to ensure that investors' voices are used for good.

Dedicated ETF teams located in major European countries bolster Amundi ETF's exceptional range of product offerings. Its diverse and highly-regarded product range, combined with its customer-centric approach make it clear to see why Amundi ETF was crowned the winner of the ETF Provider of the Year. Richly deserved!

---

[1] Source: Amundi, data for ETF products as at end of December 2020
[2] Source: ETFGI European ETF and ETP industry insights December 2020

Amundi ASSET MANAGEMENT | ETF Indexing Smart Beta

INTERVIEW

Seizing opportunities

Evalinde Eelens, board member of multiple Dutch pension funds, reflects on how the industry has exceeded expectations throughout the pandemic, what lessons we should all be learning from the ongoing crisis, and how to seize opportunities going forward in order to help the market flourish

What are your current roles in the Dutch pensions space?

Currently, I fulfil roles at four Dutch pension schemes. I am an executive board member for the Dutch industry-wide private security pension scheme, a board member for the Dutch painters' pension scheme, a board member for the PostNL corporate pension scheme and, lastly, I fulfil the role of supervisory board member for the Delta Lloyd corporate pension scheme. All of my functions have a strong focus on asset management.

The challenges of 2020 are continuing into 2021 – what has this meant for the pension funds you work with?

The initial response to the pandemic was intense and, for some, overwhelming. While the pandemic and its ripple effects were more impactful and enduring than most of us had initially expected, the pension boards were firm and swift in their response. Within days, weekly, and sometimes semi-weekly, crisis team meetings were put in place by multiple pension fund boards.

Pension funds have a long-term investment horizon so, from the asset management perspective, you are not going to turn around the investment portfolio, but you do want to be diligent. Not only were rebalancing measures widely discussed, but the real challenge was to determine if the current rebalancing policy was appropriate under the circumstances. For one fund, we decided to temporarily deviate from our rebalancing policy.

Liquidity policies proved to be adequate and, fortunately, there was no need to re-evaluate the pay-out of pensions. The pension management side, however, had to evaluate its collection policies while closely monitoring delays in contribution payments and the possible impact on the fund's liquidity position.

Finally, business continuity had to be guaranteed. The pandemic forced us to take a closer look at what to do when key people fall ill and, even more importantly, how we can prevent people from becoming ill.

All-in-all, action was taken swiftly, and different departments worked together efficiently. Everyone was committed to making things work in an efficient and new way under uncertain and trying circumstances.

How did the Dutch pensions industry cope?

The industry showed a great side of itself. Existing policies mostly proved to be adequate in unprecedented circumstances and, when needed, the pension funds were sufficiently agile to make adjustments. The commitment to solidarity increased as we were all in the same boat. Unfortunately, coverage ratios fell seriously across the board. In a 30-day time span, the possibility of pension indexation had to be substituted for a real chance of having to lower pension payouts. I am proud and relieved that none of the pension funds I work with had to cut pension payments, although it was often a close call.

The Dutch Central Bank was also involved in a very constructive way. It closely monitored our actions and initiated a dialogue to discuss the challenges we were facing.

How would you say 2020 impacted socially responsible investing (SRI)?

I am very optimistic about the SRI opportunities 2020 has provided us with. One of the most important criteria for a successful SRI implementation is the large support base that is calling for change. This past year, we have experienced first-hand what the positive effects are of less pollution. The pandemic has also forced many of us to take a more mindful approach to life and think about what really matters to us.

Looking at investment returns in the past year, many industries that are generally considered harmful to the environment have performed more poorly than other sectors. The pandemic has also confirmed that organisations with corporate social responsibility policies outperform those without such measures in place. Developing a social responsibility policy requires strategic thinking and also having the courage to make more difficult strategic decisions. The last year has shown that SRI provides great fundamentals in uncertain times.

From a professional point of view a lot has changed also. After working from home for over a year, I believe working remotely is here to stay. This will continue to have a huge impact on the way organisations operate. Meetings and daily workflows will have to be structured differently to facilitate the new hybrid way of working. Office space will be designed and arranged differently. But we also have to be more considerate of, for example, data security and how to maintain personal connections with co-workers.

Finally, from an individual perspective, like the World Health Organization recently pointed out, we have experienced how our decisions and behaviour affect not only us, but the people around us and society. Seemingly small things like wearing a facemask, practising social distancing, and observing self-quarantine requirements can have a big impact. We have become more aware of the importance of a work-life balance. Consumers have shifted to buying more local goods.

We have seen how social development goals can make a very real difference, so I am generally optimistic about SRI not only withstanding Covid-19 but in some areas benefiting from these changes in society.

One very unfortunate side effect of the pandemic is that some of the progress that was made in gender equality was undone in a worrisome fast manner. Under normal circumstances, women generally already spend more time on household duties and childcare, irrespective of professional responsibilities. Covid-19 has not only exposed existing gender inequalities, it has significantly added to them. The cases of domestic violence increased, more women than men lost their jobs, and the weight of additional household tasks landed mostly on women's shoulders. I do hope this is a wake-up call for everyone who believed gender inequality was a thing of the past and that we need to continue our concerted effort to support women and remove barriers when and where we can.

Now that we start building a new normal for the future, we have a great opportunity to do it right.

What are your priorities going forward?

The two key learning points from this crisis are that often the risk with a lower probability materialises, and that strategic agility is imperative. Scenario thinking can help to address both in an increasingly dynamic and complex environment, through the development of flexible long-term plans. Implementing scenario planning also helps combat tunnel vision and reduce boardroom blind spots. As stress scenarios become more frequent, it is essential we adapt our organisations to the current environment.

In the coming years, I would like to diversify and join boards outside of the pensions industry. Each industry offers a different experience, has its own strengths and weaknesses – sharing knowledge can really make a positive impact. That is what I look for in all my roles – to bring my experience to the table, the opportunity to learn, and the mindset to change the status quo for the better.

What needs to change in the Dutch space to enable the pensions market to flourish?

So much is going on right now in the Dutch pensions industry. The new pension deal is likely to overhaul the entire system. Everyone involved should seize this opportunity to reflect on their 'raison d'être' in pension land. What does my organisation do to make the retirement of our members an enjoyable time in their life, and how can I contribute?

On a broader level, IT, automation and data management should become a higher priority in the boardroom. In the past decades, we have seen IT develop from a mainly supportive role to a key part of the pension industry and boardroom knowledge is trailing behind. The new way of working highlights the benefits good technology can bring.

For the Dutch painters' pension fund, for example, we had to initially cancel individual consultations with participants who were about to retire. Due to IT investments, this was soon replaced with video meetings. Despite their age, the response from our participants was overwhelmingly positive, and we were able to increase the number of consultations. There are so many uncovered opportunities that can help us improve service, it is an exciting time. ■

Mesirow

Currency focus:

A WEALTH OF KNOWLEDGE

Systematic FX trading via micro and macro deep neural networks

Mesirow explains how fusing signals generated from 'micro' and 'macro' deep neural networks (DNNs) can alleviate the effects of high output variance and other issues common with DNNs

PAGE 22

Right on the money

Currency markets have become more interesting as a result of the pandemic; Lynn Strongin Dodds looks at the opportunities on offer for pension funds and the best strategies to consider

PAGE 24

INVESTMENT

Systematic FX trading via micro and macro deep neural networks

Deep neural networks-based systematic trading algorithms are usually notorious for having high output variance and for being sensitive to the length of the look-back window sizes used in creating their training sets. In this article, we explain how fusing signals generated from 'micro' and 'macro' deep neural network models can alleviate the effects of these issues.

WRITTEN BY MESIROW, VICE PRESIDENT, SENIOR RESEARCH SCIENTIST, MEHRYAR EMAMBAKHSH, PHD

Background

Machine learning algorithms are designed to automatically extract features and patterns hidden within their input data in order to perform decision making with minimal human intervention.

During the last decade, and with the availability of faster computational power and access to huge amounts of data, training deep neural networks (DNNs) has become possible, and their remarkable potential in numerous applications, such as in computer vision, natural language, and signal processing, has been revealed.

Unlike other types of machine learning algorithms, DNNs do not rely on a separate and manual feature extraction stage. They are capable of learning (spatial or temporal) patterns from the input data, while also being simultaneously optimised for various tasks, such as regression or classification.

Thanks to their non-linearity, DNNs can learn complex patterns and the temporal dependencies between samples can also be modelled via recurrent and/or convolutional architectures.

Figure 1: Illustration of systematic trading, via the fusion of micro and macro DNNs

Source: Mesirow

Designing and training DNNs with financial time series data comes with some difficulties, however, and determining the optimal amount of data inputted to train these models can be challenging.

Class over-representation vs. lack of data: Deep neural networks can very easily have thousands of parameters. To optimise over such a high dimensional parameter space, a substantial amount of data is usually required. One way to provide more training data can be to increase the look-back window (LBW) size used to construct the training sets by incorporating more historical data samples.

But more data and more training samples do not necessarily make for better models. Using a large LBW can over-represent classes and cause the models to underfit, to such an extent that the trained DNN fails to model the data accurately.

Therefore, we have a dilemma: too much data can over-represent classes causing our DNN models to underfit, but on the other hand, a lack of data can cause the models to quickly overfit (not be able to generalise unseen data thus creating a high variance in model output and accuracy).

Micro/macro DNN models

Inspired by the bootstrap aggregation (Bagging) methodology, instead of using one DNN model trained over a fixed data range, our solution to the dilemma is to increase the number of DNNs.

Our final prediction signal is calculated from several DNN models, each trained and validated over different ranges: The micro models, capable of learning immediate short-term data trends vs. the macro models, which specialise in recognising more persistent long-term trends from the input financial time series.

The micro models are trained and validated over smaller, but more recent training sets, while the macro models are trained over a much longer period.

Fusing the signals from several micro and macro DNN models reduces the large variance originated from the micro models and raises the lower macro models' accuracy, which can be caused by their high bias level and potential class over-representation. This boosts the overall performance and results in a robust technical strategy.

The diagram in Figure 1 illustrates this approach. During the live trading phase, the stream of data is given to several micro and macro DNNs, which independently execute in parallel. The output signals are then fused at the next step to generate the predicted signal.

Setup and performance

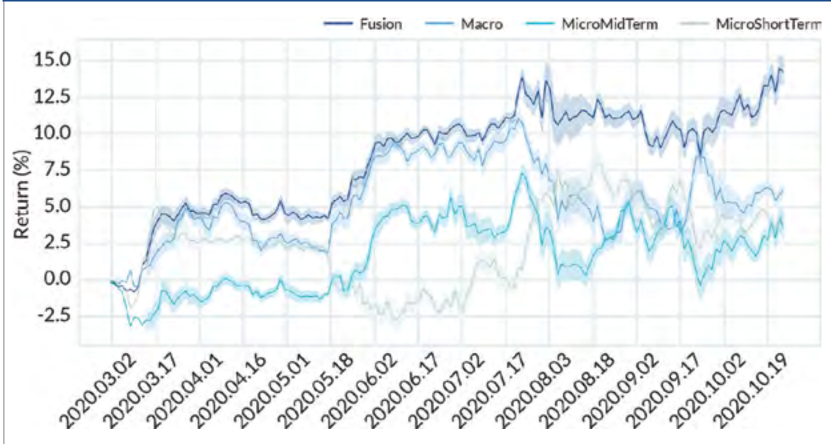
Our goal is to predict the next day's price movement for currency pair *i*, given the spot FX rates of currency *i* and other 28 currencies, during the previous *N* days. This process is repeated for all 29 currency pairs.

First, the input data is pre-processed, so that it is stationary and normalised. Then the training and validation samples are labelled. During the training step, in addition to finding the optimal weights of the DNN models, separate modules simultaneously optimise the architecture of the DNNs to automatically adjust their hyper-parameters.

Figure 2 shows the cumulative total return and rolling standard deviation in the last 11 business days, over the out-of-sample period of March to end of October 2020. Altogether, three models are used (two micro and one macro), each utilising an input tensor constructed from the FX rates during the previous *N* days from the 29 currency pairs. The predicted position sizes are then used to calculate the returns. The short and mid-term trend changes in the market are detected by the MicroShortTerm and MicroMidTerm models, respectively, while more persistent long-term patterns are discovered by the macro model. The fusion of these networks generates a robust predictive signal and provides an optimal balance between bias and variance.

This has increased the 6-months expected total return to 20.37 per cent, while reduced the standard deviation and has resulted in a 6-months information ratio (IR) of 1.85, as detailed in Table 1.

Figure 2: Cumulative returns for Micro, Macro and fusion strategies



Source: Mesirow

Table1: Six-months return and IR for individual micro and macro strategies and their fusion

	MicroMidTerm	MicroShortTerm	Macro	Fusion
IR	0.78	0.38	0.67	1.85
Return (%)	9.14	4.46	7.56	20.37

Source: Mesirow

Conclusions

This article briefly summarised the advantages of fusing several DNNs to reduce the lack of data effects vs. class over-representation in order to construct a robust predictive model. As we did not have any specific assumption about the input data, the proposed generic methodology can be applied to any multi-modal financial time series. After 18 months of research and testing, these models were added to Mesirow Currency Management's Alpha Strategies late last year. ■

INVESTMENT

Right on the money

Currency markets have become more interesting as a result of the pandemic; Lynn Strongin Dodds **looks at the opportunities on offer for pension funds and the best strategies to consider**

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

The drivers behind currency investing may not have changed, but markets have become more interesting over the past year. The picture is blurring with economies and central banks moving in different directions in terms of monetary and fiscal policy as the pandemic abates. There will be opportunities to be mined but also risks as scenarios can change quickly.

As Schroders multi-asset portfolio manager, Caroline Houdril, points out, the pandemic created an unprecedent macroeconomic landscape for investors to navigate. "We see three opportunity sets in the currencies market created by the Covid crisis – the return of the interest rate differential paradigm, the continued appreciation of commodity prices and the vaccine rollout disparity," she adds.

Emerging and developed markets

In the developed world, the Bank of Canada set the taper ball rolling in late April, becoming the first major central bank to reduce its pandemic-induced stimulus programmes. There is speculation that the Bank of England could be heading down the tightening path. The central bank's recent higher growth estimates for the UK economy – 7.25 per cent from a previous forecast of 5 per cent over three years – sent signals that rates could begin to rise in 2022.

Meanwhile, in the US, the Federal Reserve does not yet intend to pullback from its asset purchases but in early May, US Treasury Secretary, Janet Yellen, stated that interest rates may have to rise modestly to prevent the economy from overheating due to higher levels of government spending. Although no timeframe was specified, there are concerns over the impact of the Biden administration's roughly $4 trillion investment package, on top of the $1.9 trillion it pumped into the economy in March to combat the impact of the pandemic.

By contrast, emerging markets (EM) are not faring that well. Rising US government bond yields have put a damper on the EM rebound story in the first quarter and nearly all currencies in this cohort have weakened against the dollar since late February, with a slight recovery at the start of April. The greenback though is 9 per cent stronger against the Brazilian real and 5 per cent higher than the Russian rouble since the start of the year. It has also advanced against the popular Mexican peso and Chinese renminbi.

"There is not a compelling narrative because if you strip out China, growth in emerging markets is only 1.8 per cent," UBP global head of FX strategy, Peter Kinsella, says. "The FX outlook is more constructive in the G10 currencies. There was a consensus at the beginning of the year that the dollar would weaken, which would have been good for EM but that has not been the case. As a result, it is best for pension funds to focus on idiosyncratic risks and opportunities. For example, we think the Russian rouble has a strong tailwind because of rising oil prices while China's RMB will also do well."

Covid-19 impact

The vaccine rollout is also having an impact, although currently it is difficult to predict the exact outcome as countries are going at different paces. UBS head of UK balanced and currency investment solutions, Jonathan Davies, has a base case with the programme effectively stopping the pandemic and economies eventually normalising.

"At the moment, there are differences with the UK and US ahead, but I see Europe catching up in the second quarter with emerging markets and Japan following later in the year," he adds. "If the global vaccine programme is not successful in eradicating the pandemic, this may mean more structural changes to the way we live, which will produce winners and losers in certain industries, but I think growth would nevertheless return as I do not think that remaining in a perpetual state of semi-lockdown would be acceptable to the public."

Mesirow Currency Management chief executive officer, Joseph Hoffman, believes that "if the rollout of Covid vaccines across the globe improves and most countries can achieve herd immunity, this will potentially lead to a weaker dollar because investors will seek riskier assets. However, if the rollout of vaccines continues to struggle... investors may seek safe-haven currencies such as the US dollar, Swiss franc, or Japanese yen".

Strategies

Against this changing backdrop, it is no surprise that European pension funds are looking to adopt a more hands-on approach. "Although different countries have different issues, we are seeing an increased interest in active management," Millennium Global head of business development, Charles Goodman, says. "This is partly due to increased macro differentiation and a bigger opportunity set to generate alpha and for dynamic hedging."

J.P. Morgan Asset Management EMEA head of pension solutions and advisory, Sorca Kelly-Scholte, echoes these sentiments: "People tend to be anchored in what they were doing before the crisis, but we believe that a dynamic approach to currency hedging has much appeal because it can help pension funds across the board through periods of volatility and potential long-term dollar depreciation."

The fortunes of the US dollar have become more important to European pension funds as their investments are much more global today, whether it be equities, fixed income, credit or real assets, according to Kelly-Scholte. The currency may still have safe-haven status, but she expects it to depreciate over the next 10-15 years leaving investors at risk if these positions are left unhedged.

Hoffman also notes that due to the persistent low-rate environment in Europe, pension funds are paying about 80 basis points per year to passively hedge portfolio currency risk, a consistent drag on performance. For those that consider currency as an uncompensated risk, he believes a dynamic currency-hedging overlay allows investors to mitigate their FX risk, while enhancing their returns and minimising drawdowns relative to a passive overlay.

"European investors can hedge their currency exposures without incurring the substantial negative carry associated with large interest rate differentials during higher interest rate environments," he adds. "The same proactive stance is also being applied to generating performance."

As for currency alpha, Hoffman notes it can be a good investment for European pension funds that are looking for a liquid, alternative source of return due to its low correlation to equities and fixed income. "Portfolios are often constructed using currency forwards that typically do not require full funding like other instruments, such as equities or fixed income, allowing investors the flexibility to port a currency alpha overlay over other asset class investments as a return enhancer," he adds.

Some market participants also turn to the classic factor strategies such as carry, value and momentum. As Houdirl puts it, "the well-known interest rate differential dynamic has recently been rewarded in the FX market, i.e. low yielding currencies being penalised to the favour of higher yielding ones. With this factor back in fashion, we are avoiding Japanese yen and the Swiss franc for the time being and preferring currencies with earlier hiking potential like the Canadian dollar and Norwegian krone".

However, Record Currency Management CIO, Dmitri Tikhonov, notes, "although the carry trade still generates returns, investors should be aware that circumstances can change quickly and abruptly if central banks continue to intervene".

He points to the value approach as another way of producing returns. There are several ways to construct a portfolio, but he believes one of the most transparent is to benchmark against a well-known indicator such as the purchasing power parity (PPP), which measures prices of a basket of goods in different countries. Exchange rates fluctuate between highs and lows, but over time tend to return to its mean or true value.

Momentum has also proven popular, whereby trend exploits the tendency of currency returns to persist over short-to-medium-term horizons, according to Tikhonov. This means that past returns can somewhat predict the direction of future returns. ■

COUNTRY SPOTLIGHT NORWAY

A new dawn

The Norwegian pension system is ranked amongst the best in the world but, like any nation, it has issues to overcome. Jack Gray takes a look at the current state of the sector and assesses the impact recent reforms could have

WRITTEN BY JACK GRAY

Like many Nordic nations, Norway has a pension system that most countries would be envious of. The *Mercer CFA Institute Global Pension Index* recently ranked it as the joint sixth best in the world, alongside its neighbour Sweden. It scored highly for adequacy, which measures benefits, system design, savings, government support, home ownership and growth assets, and was ranked second for integrity, which is calculated on regulation, governance, protection, communication, and operating costs.

However, it is not without its issues. Norway's pensions ranked lower than its Nordic neighbours for sustainability, which is measured on pension coverage, total assets, demography, public expenditure, government debt and economic growth. Like many developed nations, Norway has problems with the affordability of legacy defined benefit (DB) pensions and an ageing population. Recent government reforms have looked to address this, but it may be too soon to assess whether they will have the intended impact.

Looking back

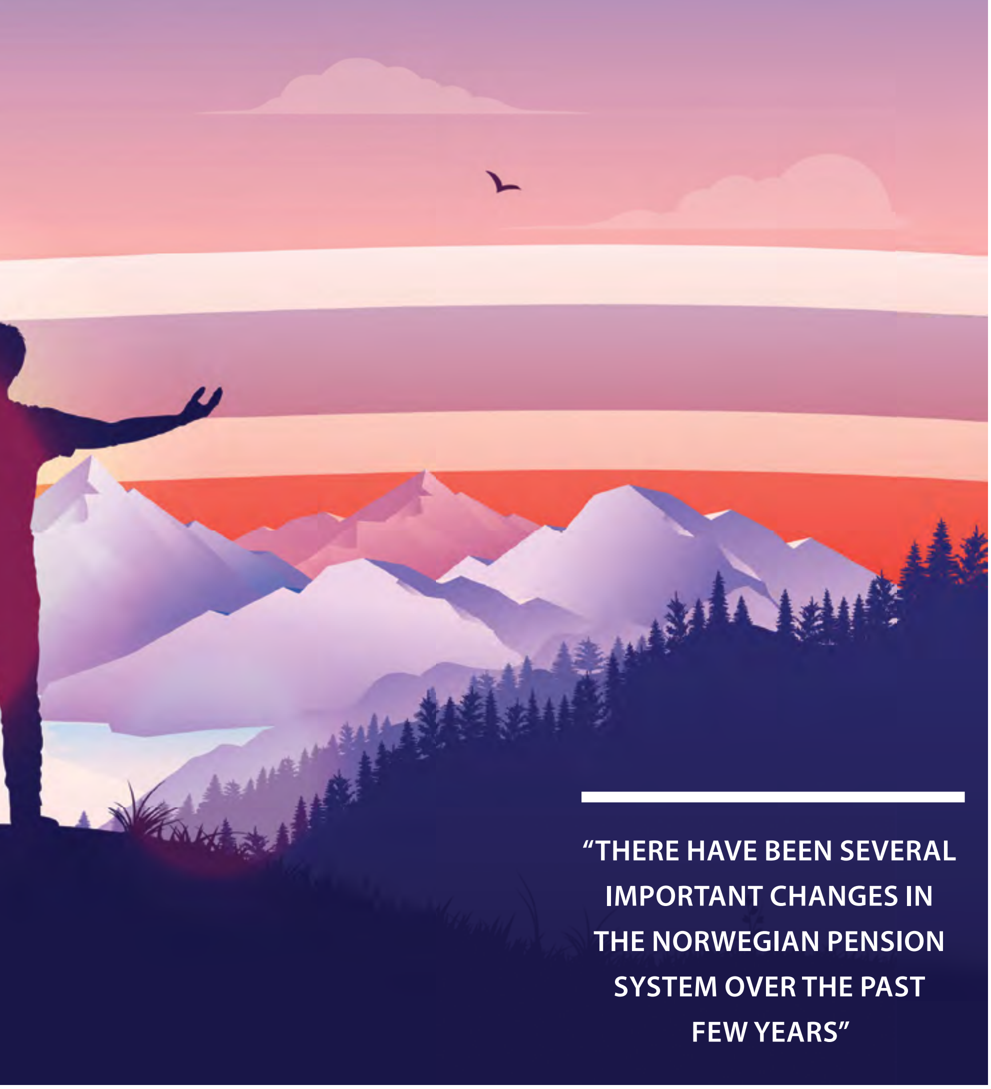
"There has been general reform work going on for some time in the national insurance system," begins Aon Norway practice director, Vidar Pedersen. "It started around the year 2000 and culminated in quite substantial reform in 2011."

At the start of the millennium, major reforms in the second pillar were introduced. Like in many developed nations, Norway sought to move away from DB schemes and enrol savers into defined contribution (DC) schemes.

"The progress was quite rapid in Norway, perhaps compared to some other countries," Pedersen continues. "It only took 10 to 15 years before 95 per cent of the DB schemes in the private sector were closed and today it is almost entirely DC, at least for new accruals."

Norway has a large public sector and although a significant portion of public bodies were privatised in the late 1980s, many continued with their DB schemes. This has caused issues in the long term, as Pedersen explains: "Over the last five to 10 years there has been some transitions to DC, but that has also led to concerns around legacy DB in the public sector. Then you get into difficult discussions around state-owned public sector schemes that do not follow ordinary practices for technical operations."

For the pillar one system, 2011 saw the introduction of the dynamic state pension age, whereby Norwegians can choose to start receiving a state pension any time from the ages of 62 to 75. An automatic life expectancy adjustment of retirement benefits was also implemented, alongside a new system of accrual of pension rights that is proportional to lifetime earnings. The underlying aim of



the reforms was to address longevity issues by providing an increased incentive to stay in the labour force for longer.

"The pension reform introduced in 2011 was important for ensuring an economically sustainable pillar one system," says Storebrand CEO, Odd Arild Grefstad. "The most important measures were longevity adjustment of pension levels and lower annual increases of benefits to pensioners. The government has started work on evaluating the reform, which could lead to adjustment. We expect the main principles to remain."

No time like the present

"There have been several important changes in the Norwegian pension system over the past few years," notes Grefstad. "In 2020 a new hybrid-based pension scheme was introduced in the public sector, in order to fully adopt the public sector occupational pension schemes to the pillar one pension reform introduced in 2011.

"This is important when it comes to giving public sector employees the same incentives to work longer before retiring as private sector employees have had since 2011. The changes are also important for labour market mobility between the public and the private sector."

Willis Towers Watson head of health and benefits in Norway, Anette Brown, describes the public sector pension changes as "important", but notes that costs for public companies have risen as a result and she is yet to see most of the effects the reform will have.

An issue felt by many pension systems that have switched from DB to DC is the increased number of small, deferred, pension pots that are being eroded by costs and charges.

"In the DC sector there were concerns around small pots for those who change employers often, as a lot of the expected pension can be whittled away due to higher costs in relation to the size of the pot," says Pedersen.

To try and resolve this issue, among others, the industry introduced the 'Individual Pension Account' on 1 January 2021, whereby former small pots were automatically imported into the scheme of a saver's current employer. At the same time, a reform was introduced to allow employees to choose their provider.

"This change provides employees with more ownership of their employer-financed pension plans and enables them to select their personal pension provider," explains Brown. "In addition, all pension capital certificates, which are pension assets accrued from previous employments, are transferred to their personal pension account.

"The reason for this legislative change was that the individual should pay less fees and thus get more pension for their investments. This, in turn, should lead to more employee engagement, new pension providers and new product innovations."

From 1 February 2021, all the individual accrued pension assets were transferred either into the employer's pension plan or to an alternative provider chosen by the employee. Brown notes that this meant that there was increased competition leading up to the implementation, as pension providers sought to secure the largest possible market share to protect their assets and give the best possibilities for growth when the capital came into play.

"This in turn drove down the asset management fees," Brown says. "As the individual now pays the same low fees as the employer, we see fees rising again as a reaction to the vendors' decreased earnings, though not to the previous levels."

These reforms were made possible by a "massive infrastructure" developed by the Norwegian pensions industry, Pedersen adds, which was not financed by the government in any way.

"The reform is based on a principle of passive consent, but employees can choose to opt out if they like," adds Grefstad. "The deadline for opting out is 30 April. At the time of writing, only 5,000 of 1.5 million individuals have chosen to opt out. The reform also makes it possible for employees to transfer their pension capital from the employer's provider to a provider of own choice. So far about 32,000 employees have done this.

"A key aim of the reform is to reduce the costs associated with the administration of pension contributions from previous employers. Regulation stipulates that individuals shall pay the same fee for former earnings from pension capital certificates transferred to the Individual Pension Account as the employer pays for current earnings.

"The reform will make it easier for individuals to keep track of their DC pension earnings, as well as introducing a right to move savings out of the collective scheme to providers of their own choice."

Future challenges

Despite the potential positives brought about by changes in the Norwegian pension system, there is scope for possible unintended consequences. Brown notes that Norwegian employees have historically been reluctant to deviate from the recommendation of the employer.

> **"A KEY AIM OF THE REFORM IS TO REDUCE THE COSTS ASSOCIATED WITH THE ADMINISTRATION OF PENSION CONTRIBUTIONS FROM PREVIOUS EMPLOYERS"**

"After the current changes we fear that a large flow of capital from the employer-selected pension providers to personal-selected pension providers will lead to premium hikes on other schemes like disability pensions and waiver of premium insurances," she continues.

"The reason being that these contracts are, in general, partially subsidised by the pension provider in order for them to retain the assets in the DC plans. One strategy we use to combat this is to communicate the benefits of not choosing your personal pension provider."

Pedersen adds that although the "more than expected" uptake in people choosing their provider was helped by offerings in the market from labour unions, he is not sure whether this is beneficial for the industry.

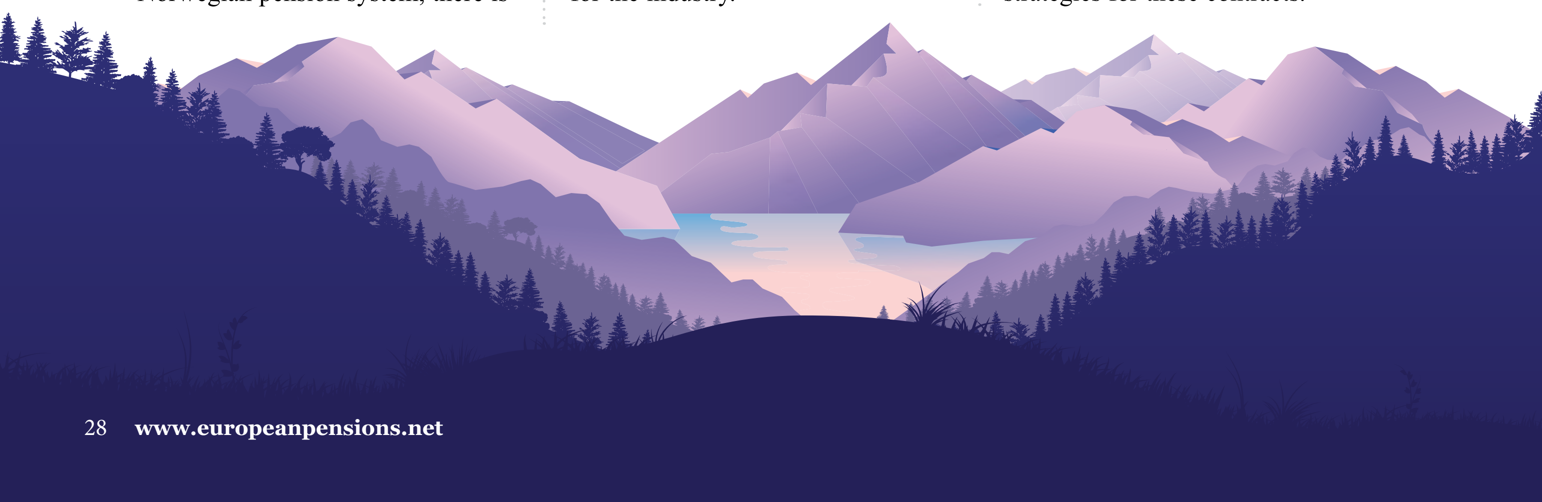
"If the unions become more influential, it's the classic triangle of influence with each trying to control the system as much as they can," he notes.

Brown also warns that employers could be liable if an employee later claims that they were not sufficiently informed of the consequences of the Individual Pension Account.

One issue that a solution is yet to be found for is with legacy DB schemes, which are becoming increasingly expensive to administer. Pedersen notes that company executives are not focusing on DB schemes any more and there is some concern that they could be forgotten, posing financial challenges in the long term.

"The back book of paid up policies from the DB schemes remain a challenge," concurs Grefstad. "We expect the government to propose changes in regulation of these and other guaranteed pension products this year, with the aim of facilitating more risk taking, leading in turn to higher expected returns and higher benefits.

"As a result of low interest rates and particular Norwegian regulation with one-year return guarantees, and limited use of available buffer capital, paid up policies are mainly invested in long-term bonds and have received little return above annual guarantees. Hopefully, new regulation will make it possible to have better long-term investment strategies for these contracts." ■



INTERVIEW

Be the change you want to see

KLP vice-president for corporate responsibility, Heidi Finskas**, talks to** Jack Gray **about how Norway's largest pension company and public service pension scheme dealt with the Covid-19 pandemic, its ESG strategy and its plans for a net-zero future**

WRITTEN BY JACK GRAY

How was KLP and its investment returns affected by the coronavirus pandemic in 2020?

KLP was negatively affected by the market developments caused by the pandemic at the beginning of last year. We had, however, a decent regain during the second half of the year. In hindsight though, we could have had more risk on the balance during the second half. We are pleased that our strategy ensured solvency and returns in a challenging year. All-in-all, we managed well through a turbulent period of time.

KLP has been vocal and active on environmental, social and governance (ESG) issues – including on human rights, the Amazon rainforest and excluding fossil fuel companies. What is KLP's responsible investment policy?

The sustainability challenges the world is facing are urgent. Institutional investors have a key role to play – from a risk perspective, where sustainability issues are representing a financial risk both on a macro and a micro level, and from a moral perspective where investors have to acknowledge our role in negative impacts from businesses, and our responsibility to act.

KLP's strategy is based on three main ways of acting:

1. We increase climate-friendly investments, for example renewable energy. Already today, about 5 per cent of KLP's assets under management are in renewables. Our target is to invest NOK 6 billion more every year.
2. We try to influence companies through dialogue about ESG issues and through being clear on our expectations. We often support ESG-related resolutions at annual general meetings, and we initiate and support investor coalitions engaging with companies on these issues with a united voice.
3. Exclusion is our last resort when engagement is not a realistic option or is not leading to the desired outcome. For instance, we have for several years already excluded the most carbon intensive fossil fuel sources, ie coal and oil sand, as these will be difficult to align with the ambitions set out in the Paris Agreement.

What drove the pension scheme's adoption of this policy and did you have many members pushing for responsible investment?

Our members and owners told us that responsibility and sustainability are important to them, and then it was our job to find out how best to integrate that into our investment policy, both from a risk and responsibility perspective. KLP has had a responsible investment policy since the 1990s. When we first adopted the exclusion approach around 2000, it was because of a push on tobacco from our members and owners in the health sector. They did not want to finance the tobacco industry with their pension savings, as they saw the tremendous costs smoking had for society.

What are KLP's targets and plans for the near future?

We are currently operationalising our net-zero ambition, with metrics and trajectories for all parts of the portfolio. Our objective is to have a portfolio aligned with the Paris target. Climate is a top priority, both when it comes to climate stewardship in general, as well as financing the transition we have ahead of us, and gaining a better understanding of how to manage climate risk in a diversified portfolio such as ours. ■

Bogazici University PhD candidate

Auto-enrolment: Not a lifeboat for EM countries

WHY EM COUNTRIES SHOULD CONSIDER ADDITIONAL OPTIONS TO AUTO-ENROLMENT

With the rapid ageing trend in less developed parts of the world, emerging market (EM) governments are aware that they should boost pensions for retirement security. In parallel with this target, they have already introduced some policies, such as tax advantages, financial incentives, and education campaigns for retirement plan participants.

However, looking at the current situation, the majority of EM countries still have limited pension savings. As a recent step, some EM governments have adopted auto-enrolment policies to build up pension pots. In the past five years, five EM countries have introduced auto-enrolment, inspired by the remarkable success of this behavioural policy in developed countries, such as the UK and New Zealand.

Starting with Chile in 2015 and Turkey in 2017, three more Central Eastern Europe (CEE) countries – Poland, Lithuania, and Georgia also introduced auto-enrolment in 2019. Indeed, when looking at the features of these auto-enrolment programmes, they are not much different than those in developed countries. Regarding financial incentives, both tax advantages and employer/state subsidies are available, being more generous in Poland and Turkey.

But what are the opt-out rates in EM auto-enrolment systems? In Chile, opt-out rates are about 75 per cent. While in Poland, almost 70 per cent of participants exit from the auto-enrolment system; in Turkey, this ratio is close to 60 per cent. These opt-out rates are considerably higher compared to the experiences of the UK and New Zealand, where less than 15 per cent of participants exit from the system.

An investigation of the reasons behind these high opt-out rates in EM countries reveals that the high share of low-income and informally employed groups are two main barriers in achieving high participation rates in auto-enrolment schemes. For example, while in countries like New Zealand and the UK, the GDP per capita is higher than USD 40,000, in EM countries such as Poland and Lithuania, it is less than USD 20,000. Furthermore, the informal sector is a large source of total employment in countries such as Chile and Turkey. Considering that EM countries need long-term reforms to reduce poverty and informality, they should find alternative ways to auto-enrolment to boost their retirement savings.

At this point, EM governments may incorporate behavioural and technological solutions to increase pension savings among the low-income and informal population. Before concluding, here are two suggestions from recent initiatives: Saving through consumption platforms – in these applications, a certain amount of individuals' daily purchases (e.g., food and clothes) is automatically transferred to their saving accounts. In other words, these platforms transform individuals' spending behaviour into a saving habit.

Considering that consumption accounts for more than 60 per cent of EMs GDP, 'saving through consumption' apps may have significant potential to promote pension savings among low-income and informal populations. Some examples of these platforms include the Miles for Retirement (Mexico), Pensumo (Spain), and SuperSuper (Australia).

Secondly, is digital micro-pensions – in most private pension schemes, employees' contributions are deducted from their salaries at fixed amounts as monthly payments. However, since low-income and informally employed groups have irregular income flow, they are more inclined to make small payments at flexible time intervals. In this regard, micro-pension apps, such as 'PinBox Solutions', allow their participants to contribute to their savings accounts in small amounts at daily and weekly frequencies.

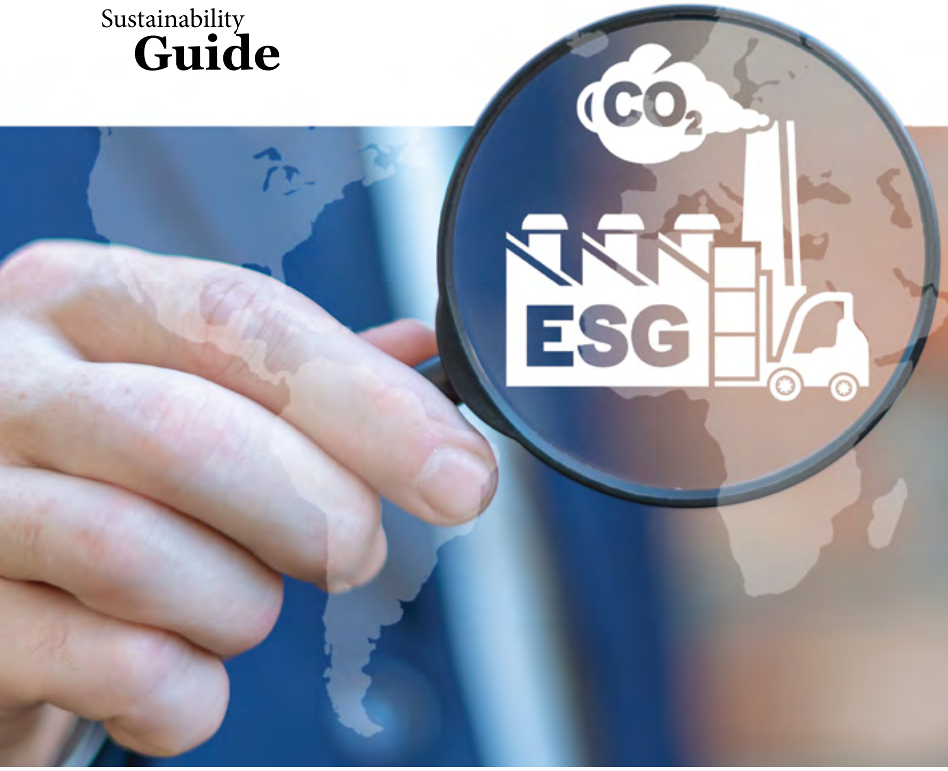
So far, auto-enrolment policies alone do not seem to be a lifeboat for EM pension systems, where the high share of scheme participants has low and irregular income. To this end, other EM countries that have plans to introduce auto-enrolment, should consider adopting complementary solutions to this behavioural policy to ensure adequate pension savings. ■

"SO FAR, AUTO-ENROLMENT POLICIES ALONE DO NOT SEEM TO BE A LIFEBOAT FOR EM PENSION SYSTEMS"

Written by Seda Peksevim Pension Researcher/PhD Candidate, Bogazici University, Turkey

Sustainability Guide:

ON THE RIGHT PATH



SFDR REGULATIONS

Duncan Ferris examines the new SFDR requirements that pension schemes are getting their heads around, looking into how the industry has reacted to the regulations, how much demand schemes have felt from their members and how challenging adhering to the new rules might be

WRITTEN BY DUNCAN FERRIS

SFDR: A closer look

Level one of the European Union's new Sustainable Finance Disclosure Regulation (SFDR) took effect in March, increasing the environmental, social and governance (ESG) responsibilities for financial market participants such as pension schemes. In essence, these mean that schemes are now required to disclose information about their policies regarding the identification and prioritisation of things that will impact sustainability. These disclosures will need to be present on the market participants' websites, prospectuses and periodic reports. Level two disclosures, which are set to be even more comprehensive, will come into force from 1 January 2022.

Objections?

It is no secret that pension schemes are becoming more aware of the importance of ESG and they are seemingly becoming more active in ensuring that they do not shy away from the issue. Mercer's *European Asset Allocation Insights 2020*, published last August, showed that 54 per cent of European schemes were now actively considering the impact of climate risks, compared to just 14 per cent in 2019. The same research found that 89 per cent of schemes considered wider ESG risks as part of their investment decisions, up from 55 per cent in 2019.

However, this increased attention to the issue of ESG does not mean that all aspects of SFDR in its current form have been welcomed with open arms by the European pensions industry.

Ravien Sewtahal, responsible for ESG at Stichting Pensioenfonds Medisch Specialisten (SPMS), says: "SPMS welcomes further harmonisation of ESG reporting and sees the SFDR regulation as paramount to achieving that objective. As such there is no objection to the SFDR requirements as a general concept.

"We do acknowledge that the SFDR regulation is not complete yet, and may incur costs from a data perspective at some point. We are actively seeking collaboration with our stakeholders and peers to balance potential extra costs with complying with SFDR."

PensionDanmark head of ESG, Jan Kæraa Rasmussen, goes further, stating: "Overall, we are strong supporters of the broad sustainability purpose of the SFDR but there are many details that we need to work with during implementation before we can make the final judgement."

However, AMF sustainability manager, Anna Viefhues, is more positive, commenting: "We share the ambition of the European Commission to increase transparency on sustainability. This is something that we have focused on for many years in the Swedish finance sector, for example, developing a national market standard for sustainability information. This standard will now be replaced by the new SFDR requirements."

Eversheds Sutherland pensions partner, Eric Bergamin, points out that the different forms that pension schemes take in different countries can cause friction. He explains: "Pension funds in the Netherlands are mainly seen as social institutions, not as financial institutions like banks and insurance companies. The SFDR regulation focuses on rules for financial institutions Pension funds, at least in the Netherlands, have a different way of disclosing information and communication to members."

He adds that funds are generally not subject to competition as approximately four-fifths of the nation's pension fund members are in mandatory sectoral funds, further entrenching the funds' distinction from financial institutions.

Bergamin then states that "current figures show that a large number of pension funds have chosen to opt-out of the SFDR rules", noting that SFDR was "not well received in the Dutch market".

He concludes: "My personal view is that the hesitation or even resistance against SFDR is not based on resistance against ESG investments, but against the rules not being adequate and tailormade for pension products, as offered in the Dutch market."

Demand

ESG has been a hot topic in the industry for several years at this point, but how much demand is there from actual savers and professionals for information about how their savings are being invested, or how their workplace is using its money?

A spokesperson for Aviva Life & Pensions Ireland DAC makes it sound fairly straightforward, stating: "We are seeing an increase in interest by pension fund trustees, brokers and customers in how their funds are invested and an associated demand for ESG funds, which we expect will increase in the years to come."

Sewtahal is on a similar wavelength, explaining: "SPMS is increasingly experiencing a demand for transparency and ESG-awareness at our pension fund by our scheme participants. We welcome this development and take into account input from our participants as well in further developing our ESG policy."

In February, Morningstar highlighted the increased interest in ESG as it stated that sustainable open-end and exchange-traded funds available to European investors had attracted net inflows of €233 billion in 2020, noting that this was almost double the amount from the previous year.

However, this response appears not to be as universal as one might expect when it comes to pensions, with the demand clearly falling short of being a near-rabid hunger for pension schemes to formulate refined ESG strategies.

Rasmussen comments: "We feel that the demand is not yet huge for all of our members, but the demand is certainly in good growth, and our stakeholders among the social partners are very focused on sustainability."

Viefhues adds: "We see an increased interest, but it cannot be compared with, for example, consumer products. Our own surveys show that many savers expect pension companies to act and invest responsibly, and that climate is one important issue that they expect pension companies to work with."

Challenge

It is also worth examining how challenging pension schemes will find it to adhere to SFDR requirements. Rasmussen acknowledges that, for some of the required indicators, the availability of meaningful data presents a "challenge", though he argues that he believes this difficulty "will be mitigated in the next few years".

Sewtahal appears to agree regarding these difficulties, stating: "SPMS has already started collecting ESG data on its portfolio with the objective to further tailor our ESG policy. We acknowledge that ESG data is still in its early stages, for example there is no international accounting standard on how to define ESG metrics.

"As such we welcome the SFDR regulation and will use that as our starting point. The biggest challenge right now is waiting for more clarity on the SFDR level two data reporting requirements, and the associated costs of accessing that data."

However, accessing meaningful data is not the only challenge, as making reporting accessible for customers is also a concern for some schemes. Speaking about AMF's experiences to date, Viefhues comments: "In March, we reported on the level one requirements for the first time, and for example labelled our traditional insurance product 'light-green'/Article 8.

"Implementing the reporting criteria in the regulatory technical standards will of course be a much larger project, and we, and I guess all our peers in the sectors, are struggling with interpreting the different requirements right now.

"One of the largest challenges, besides challenges with collecting data on the different indicators we should report on, will be to make the information easy accessible and understandable for the end-customer, and thus achieving the main purpose of the regulation."

Ultimately, it seems that the challenges schemes will face when it comes to SFDR implementation may lessen as the industry adapts to new responsibilities.

The level one requirements will allow schemes to dip their toes in the water before the next round of regulations come into force next year. ■

ESG INVESTMENT

How to give all investors voting power within pooled funds

As an open architecture platform, at AMX, we aim to instil an ethos of sustainability and help improve environmental, social and governance (ESG) practices among investors, managers and other service providers in the asset management ecosystem

WRITTEN BY RYAN TULLY, BUSINESS DEVELOPMENT AMX

Whilst our industry, as a whole, has responded well to the call for choice in investment strategies in line with a growing focus on environmantal, social and governance (ESG), there exists a significant governance challenge for schemes, which has largely been unresolved, namely operational governance around stewardship.

A platform's focus on operational excellence offers a better way to address this notable 'governance gap' that currently exists in pooled funds. Importantly, the unique position of a platform allows for connection across a number of vendors, allowing the investor choice based on their specific needs.

Stewardship - the governance challenge faced by trustees

Pension schemes are under increasing pressure from regulators and members to integrate sustainable investment practices. Where trustees have not developed their own policies, they should be familiar with their asset manager's polices and where appropriate, seek to influence them.

The Department for Work and Pensions issued specific guidance in February 2021[1] which stated:

"Trustees should be clear on how stewardship fits within the scheme's investment strategy and how it helps them meet their climate-related objectives.

"Where they delegate to asset managers, trustees should carry out due diligence, ensure their approaches are in line with the trustees', set expectations, and hold managers to account."

Furthermore, the guidance also stated: *"Trustees should document and disclose their own stewardship policies, report on how they have followed them."*

And yet, with \$50 trillion AUM globally held in pooled funds[2], the challenge remains: how to exercise this stewardship responsibility within these funds?

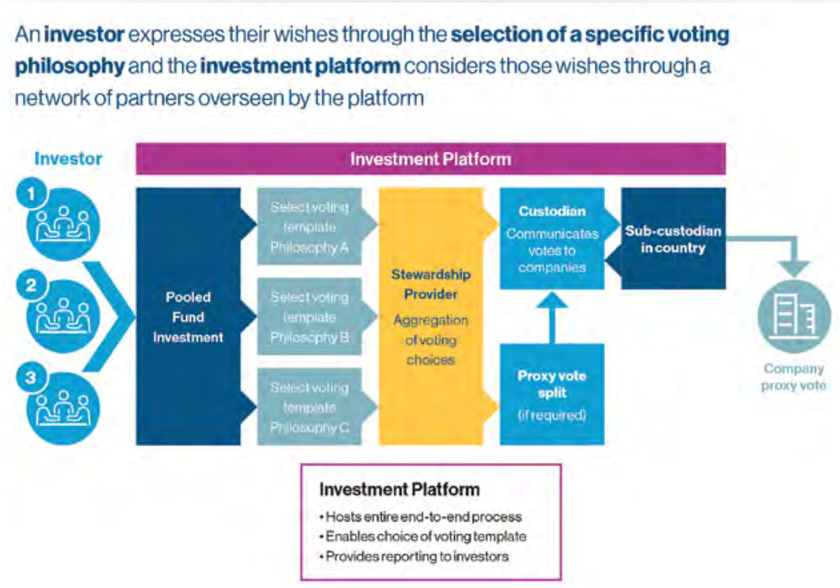
Historically, investors in pooled fund structures have had little choice in how their voting rights were exercised. Fund managers would have voted on behalf of their investors but, where investor preferences diverged from the manager's own policy, it's the investor who has been forced to accept the votes placed by the manager, often with very little power to voice their views on issues such as on diversity of workforce.

That being said, the industry has responded by producing guidance on how to exercise stewardship through the use of voting templates, which is a way for investors to communicate their voting preferences to their investment managers.

However, many managers are still not geared to aggregate the voting preferences of multiple clients within pooled vehicles, nor have they demonstrated the flexibility to offer independent stewardship overlays for their pooled funds. Schemes which invest in pooled funds are reliant on the underlying manager's voting policies and initiatives such as the Association of Member Nominated Trustees' (AMNT) Red Line Voting and calls to managers for 'comply or explain' have been frustrated by limited action and innovation in these important areas.

Why have asset owners been unable to express their stewardship preferences in pooled funds?

Asset owners have little choice	Investors in pooled funds have had little choice as to how their shareholder rights were exercised – the fund manager would carry this out on behalf of all the pooled fund's investors in a standardised way.
Inertia	Inertia, lack of investment in voting technology, and a general reluctance from investment managers to innovate in this area has limited the options available for investors.
Limitations of influence	Investors can choose ESG investment strategies that reflect their values but they have been unable to influence the votes taken within these pooled funds.



How institutional platforms provide stewardship solutions

A platform, with expertise in managing operational governance, allows the unbundling of stewardship activities from the manager implementing the investment strategy within a pooled fund. For some time, pooled funds have been available in the market which utilise a separate stewardship provider from the underlying manager. Investors can be confident that a general, proactive stewardship policy is in place for their investment and they have no need to lobby the asset manager to adopt their views.

A solution now also exists to address the challenges for investors in exercising their stewardship responsibilities across multiple pooled equity funds. Using a network of partners, a new service allows the aggregation of investor stewardship preferences for each voting philosophy, using templates such as the Pensions and Lifetime Savings Association's voting guidelines or AMNT'S Red Line voting principles. The votes will then be executed in alignment with these individual templates. Where voting philosophies may conflict on a specific vote, it is the intention to split the vote according to the proportional share of the underlying voting philosophies. This innovation offers the ability for investors to vote in line with their values whilst enjoying the benefits of a pooled fund.

How it works in practice:

- Each investor makes an investment into the same pooled fund on the platform. The investment manager can manage equity strategies within the pooled fund. At onboarding the investor selects their preferred voting philosophy from a standardised template or by the creation of a bespoke template.
- The stewardship provider develops the rules for each philosophy to create a voting template which guides how votes are expressed. They aggregate the unit holder positions in the fund to determine the total assets guided by each voting template. And finally, they communicate the vote decision to the custodian for the fund. In some cases, this may be a split vote within the fund.
- The custodian and their proxy implementation vendor allow the stewardship provider to cast the vote(s). After recording the vote(s), the confirmation process returns through the same chain.
- Reporting is provided by the platform to each investor on how the votes were cast. Reporting helps the trustees prepare their Implementation Statements, but with an important twist. The 'material votes' included in the Implementation Statement will have been selected by the investor, not by the manager.

An investment platform is in the unique position to work with multiple stakeholders and partners, through the ecosystem it has built up, to solve operational governance gaps, paving the way for more industry participants to respond in kind. Now that the 'impossible' is indeed possible, all trustees are in a position to demand independent stewardship services for new equity pooled fund tenders by institutional investors.

This paradigm shift will begin the transition of voting power from investment managers to the rightful institutional investors owners and will increase the speed by which important climate change and governance issues are addressed by corporate stewards across the globe. ■

In association with

AMX

[1] *www.gov.uk/government/publications/aligning-your-pension-scheme-with-the-taskforce-on-climate-related-financial-disclosures-recommendations/part-2-quick-start-guide-trustee-governance-strategy-and-risk-management-how-to-integrate-and-disclose-climate-related-risks*

[2] *www.pwc.com/gx/en/industries/financial-services/assets/wealth-management-2-0-data-tool/pwc_awm_revolution_2020.pdf*

ESG INVESTMENT

Why less carbon means stronger growth for the global economy

WRITTEN BY AXA IM CIO, CORE INVESTMENTS, CHRIS IGGO

As long-term investors, we always need to have an eye on sustainability – sustainability of business models, of earnings growth and the ability to manage risk.

Sustainability, however, has taken on a new meaning in recent years. It is widely agreed that climate change poses a huge threat to the world – to our societies and economies. Quite simply, without the transition to a low carbon economy, we won't have sustainable economic growth, and that means we can't have sustainable investment returns.

The economic hit from COVID-19 has seen unemployment rates go up and businesses go under. A recent report from the Organisation for Economic Co-operation and Development highlighted that government borrowing in the world's richest economies surged by a record 60 per cent in 2020, double that of the 2008 financial crisis. The world needs greater GDP expansion and less toxic emissions.

Fundamentally, I believe lower carbon will mean more growth. But achieving the Paris Agreement goal of limiting warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels will require substantial investment. If we do nothing, scientists believe that global temperatures will rise by more than 3°C.

We know that would be very damaging to the environment. It will result in rising sea levels, extreme weather, societal disruption, the loss of economic activity and more.

The energy transition will take us beyond the fuels that have driven the global economy for the past 200 years. Instead we need to rely on renewable energy and achieve greater energy efficiency. This will impact not just power generation but transport, industrial processing, agriculture and the buildings in which we live and work.

Government backing

Governments are thankfully pledging to invest billions into the energy transition – and setting some very ambitious targets. In 2020, the European Union unveiled a recovery deal which included some €550bn earmarked for green initiatives – the biggest single climate pledge ever made. China, the world's biggest emitter of carbon dioxide, has committed to carbon neutrality by 2060.

France has set itself the goal of becoming the first major low-carbon economy in Europe, after announcing a €100bn post-COVID-19 rescue package, of which a third is dedicated to climate-related projects. Australia, home to some of the world's largest coal mines, is aiming to have 94% of its electricity generated via renewables by 2040.

US President Joe Biden has yet to set out his stall in full, but climate is high on his agenda – and he has already said he wants to convert around 645,000 federal vehicles to electric power. In November this year, we have the delayed United Nations climate change conference COP26 in Scotland. As it approaches, we will likely hear more governments refresh their energy plans and carbon reduction targets.

Growth opportunities

Policy and technology are driving the economics of the transition. In our view, the energy transition will be as transformative for the world economy as the digital revolution has been since the 1980s. Over recent years there has been a huge amount of investment into renewable energy, with generation soaring by 57% between 2010 and 2018. The share of renewables in global electricity generation had risen to nearly 28% by the first quarter (Q1) of 2020.

This increase has come mainly at the expense of coal and gas, though these still represent close to 60% of global electricity supply. In Q1 2020 variable renewables – solar and wind power – reached 9% of generation, up from 8% a year earlier.

The potential is huge. There are going to be significant growth opportunities as a result of this shift towards renewables. Research shows that clean technology has the potential to drive $1trn to $2trn a year of green infrastructure investments while creating some 15 to 20 million jobs globally. Renewable energy could be the largest area of spending in the energy industry in 2021, surpassing oil and gas.

For investors, I believe, there is a need to start adjusting portfolios now. We all need to reset what we think will be the drivers of economic growth over the next decade and beyond.

Cutting carbon

The reliance on oil and other fossil fuels has led to enormous political problems – even war – over the years. Moving to renewable energy brings immediate benefits. It lowers the external costs – things that can affect everybody, such as healthcare costs from heat waves and droughts, and loss of property from flooding.

It is widely recognised that we need to internalise those costs by putting a price on pollution. Meanwhile, the costs of renewable energy sources have fallen dramatically; the levelized cost of electricity from renewable energy – the cost of electricity over the entire life of a power project – is now lower for renewable than for coal-fired electricity generation.

At the same time the price of carbon is rising. There are various frameworks, or emission trading systems, which aim to put a price on carbon. Companies in certain industries need to pay for the right to generate carbon emissions and the price is going up. More of these trading systems are being established and they are going to help internalise the costs of carbon emissions – if you generate CO_2, you will pay for it, and pay more in the future. This dramatically changes the economics of some business models and should lead to greater efficiency because of lower, more stable energy costs.

The transition

It is not easy to replace fossil fuels. Goldman Sachs created a so-called 'carbon curve' that estimates the cost of moving from 'business as usual' to replacing primary energy sources with renewable energy. That cost curve eventually gets very steep. For some activities – power generation, agriculture and other land use – this is less problematic and more straightforward. We are witnessing big growth in electric vehicle usage – global sales of electric cars accelerated by 43% in 2020 despite an overall slump in car sales. Electric vehicle numbers remain relatively small, but their uptake is expected to grow.

However, for other sectors – industrial processing or air transport and shipping – moving to renewable energy is very expensive. New technology may help. Hydrogen has barely scratched the surface of its potential as a fuel source for industry and transport, while carbon abatement technology is improving, and providing lots of growth and investment opportunities. The fact that renewable energy still accounts for only 28% of global electricity generation means we still have plenty of room to grow.

The cost curve of the transition is ultimately flattening because of the investment we are seeing in new technology, government policy support and allocation of capital to low carbon technologies. Saudi Arabia's planned zero emissions city in the desert is going to rely completely on renewable energy and new technologies –a real-life experiment to show how we might make our lives more sustainable.

The long-term benefits of the transition

As investors, we need to think about the structural trends that will generate economic growth in the future. We believe that means decarbonising portfolios and investing in climate solutions. It means thinking about how to generate earnings growth as business models change and we all benefit from more economic growth and less carbon. Traditional oil and gas producers are adapting business models – they know that if they do not, they will be left with stranded assets. We are not going to move to zero oil and gas; companies will still do what they are doing today but they are moving very quickly into the renewables space.

The lower carbon economy doesn't mean less economic growth – it means more – and the risks of doing nothing are much too high. This journey will involve billions, if not trillions, of dollars of investment over the next few years, bringing very exciting technological opportunities. The energy transition will not just create jobs for displaced oil and gas workers, but new positions in new locations, as new energy sources become more spread out around the globe.

We need economic growth to return but we also need to reduce carbon emissions. I believe the energy transition can deliver both short-and-long-term benefits – there are huge investment possibilities and massive opportunities in terms of how it affects business models going forward. Investors need to be ready to play their role. ■

In association with

AXA Investment Managers

---

[i] Government Borrowing Jumps by Most on Record in Covid Pandemic - Bloomberg
[ii] https://www.gouvernement.fr/en/european-aspects-of-france-s-recovery-plan
[iii] Climate Change Response (Zero Carbon) Amendment Act | Ministry for the Environment (mfe.govt.nz)
[iv] AEMO | Australian Energy Market Operator
[v] International Renewable Energy Agency; Renewable Power Generation Costs in 2019.
[vi] Renewables – Global Energy Review 2020 – Analysis - IEA
[vii] Goldman Sachs | Insights - Carbonomics: The Green Engine of Economic Recovery
[viii] Carbonomics The green engine of economic recovery (goldmansachs.com)
[ix] EV-Volumes - The Electric Vehicle World Sales Database (ev-volumes.com)
[x] Saudi Arabia to build a zero emissions city | News | DW | 11.01.2021

AMX

AMX (The Asset Management Exchange) is an institutional platform that gives investors and asset managers a way to do business with each other and is built with fund infrastructure that's designed specifically for the needs of institutional investors.

AMX provides centralised back office and standardised fund infrastructure, reducing cost and resource duplication, delivering scale benefits to both sides of the market while increasing transparency and improving operational governance.

Managed by a 100-strong team who negotiate with managers, transition assets, monitor strategies and add an extra layer of risk oversight, AMX is accessed by an online portal, AMXConnect, that allows investors and managers to interact seamlessly with each other.

AMX aims to support the emerging taxonomies in sustainable finance to provide transparent reporting and insights to end investors and engage with relevant industry movements that champion responsible investing.

AMX standardises, centralises and streamlines the entire process so it works better for everyone.

To find out more visit **theAMX.com.**

AXA

AXA Investment Managers (AXA IM) is a responsible asset manager, actively investing for the long-term to help its clients, its people and the world to prosper. Our high conviction approach enables us to uncover what we believe to be the best global investment opportunities across alternative and traditional asset classes, managing approximately €858 billion in assets as at the end of December 2020.

AXA IM is a leading investor in green, social and sustainable markets, managing €555 billion of ESG-integrated, sustainable and impact assets. We are committed to reaching net zero greenhouse gas emissions by 2050 across all our assets, and integrating ESG principles into our business, from stock selection to our corporate actions and culture. Our goal is to provide clients with a true value responsible investment solution, while driving meaningful change for society and the environment.

INTERVIEW

Making a statement

Duncan Ferris **chats with Pædagogernes Pension (PBU) chief investment officer,** Carsten Warren Petersen**, about tackling market volatility, innovative solutions for raising member satisfaction and making a statement through investment**

WRITTEN BY DUNCAN FERRIS

What advantages does PBU's member ownership structure bring?

We are a labour market pension fund so in order to be a member you need to be an early childhood teacher. We have more than 100,000 members in Denmark, who take care of preschool kids. This means that our members are quite similar in several ways, as they have the same education, they work in the public sector and they have similar wages. This means we can find one-size-fits-all solutions, in terms of our various products, which keeps our costs very competitive.

This is one of the reasons that we are among the cheapest schemes per member in terms of our administrative costs and investment costs. We have tailor-made solutions to a specific and large group of people. We have around €10 billion in assets under management, which also helps in getting competitive prices in our various investments.

The scheme achieved returns of 4 per cent and 9 per cent for its oldest and youngest scheme members, respectively, in 2020. How did PBU achieve this in the face of the market volatility seen in the past year?

A lot of those in our peer group are investing in alternatives and illiquid investments, but we are not really doing that a lot. We have focused on keeping a highly liquid portfolio with listed stocks and bonds. We do have unlisted funds and investments in infrastructure, but we have hardly any private equity. This has worked quite well for us in terms of a low complexity, as we have quite a small team and quick decision-making processes on the portfolio level.

We have also been reducing the number of names in our equity portfolio. Before we had thousands of names and now we are aiming to have below 400 names, with this low name turnover having kept us very focused. Then, in the unlisted space, we have a few select partners whom we have large allocations with, but we limit the number of funds that we are dealing with. We keep things simple with real assets and are laser-focused on having the right level of risk throughout the year. This has worked well for us and positioned us well in a difficult investment environment, considering where rates and inflation are going. It is important to keep your options open and not lock yourself in too much.

The fund has recently begun investing to support women's independence and rights in Asia. How do you engage with your members to decide upon social causes to invest in?

We annually meet with representatives of our members and there are also member representatives elected to our board. We also have a strong active dialogue with our members and it is really a benefit that they are a specific, and in some ways, similar group of people. This also means that through discussions we can identify their values and give them a platform.

We are also aware that there has been a lot of focus on the 'E' in environmental, social and governance (ESG), which is important, but the social dimension is also key. So, we take action with our members and look for possibilities around the world, which is not easy because there needs to be proper due diligence processes and legal set ups for us to be allowed to invest, because we are essentially investing other people's money. We are on the lookout for possibilities in microfinance and helping female entrepreneurs in Asia.

You have recently excluded 144 companies due to dependency on coal and oil, or due to a lack of confidence in their business model. How did the scheme evaluate these companies?

We have an in-house ESG unit and they draw on a number of external resources to evaluate companies. We really do prefer active ownership, so exclusions are a big deal for us. You leave the table when you exclude a company, which may make a statement but our first preference is always active ownership. There was a careful consideration of the excluded companies, but we review and update our exclusion lists on a regular basis. This means we are communicating to them that if they do make a change, they might find themselves within our investment universe again, which is hopefully a motivating factor.

Obviously, one investor cannot do much here, but more of us acting like this should influence companies and we have really seen a lot of companies reacting to key investors' opinions about climate issues over the past couple of years.

In terms of risk, the exclusions have not inhibited us. We prefer not to do sector exclusions, instead we act on a name basis. There are very few areas, such as arms manufacturing, where we have gone for more of a sector exclusion.

2020 saw the scheme open a new counselling centre – how much has this helped to improve member satisfaction?

Our members can call in with questions about pensions that might arise after life-changing circumstances, such as going through a divorce. Our counsellors who answer have often previously been employed as early childhood teachers, so they are able to have an understanding of our members' priorities. We are very focused on delivering clear and top performing communication in our interactions with members about what is a very difficult subject for a lot of people.

> **"WE REALLY DO PREFER ACTIVE OWNERSHIP, SO EXCLUSIONS ARE A BIG DEAL FOR US. YOU LEAVE THE TABLE WHEN YOU EXCLUDE A COMPANY, WHICH MAY MAKE A STATEMENT BUT OUR FIRST PREFERENCE IS ALWAYS ACTIVE OWNERSHIP"**

I think it has been very beneficial that we can carry this out in-house, rather than it being outsourced. This means we can ensure there are no limits on how long a counsellor talks with a specific member, as they are not required to make 10 calls a day or meet any sort of target.

What other measures have helped to keep the scheme's members satisfied?

We try to be on top of communication in terms of reaching out and making ourselves accessible to members by phone, social media and even snail mail! We are also trying to specifically get hold of younger members because they can benefit from starting to save early through compound interest and returns. It can be tough to get people interested so making it appealing is something that we have been thinking about a lot.

If you have been aware of your pension fund for a large part of your life and you have noticed that the returns have been good and that the scheme has been investing in a responsible way, that could increase your sense of being satisfied, even though some people see it as something of low interest.

Are there any further issues that PBU is interested in tackling?

We are quite concerned about aggressive corporate tax avoidance. Our members, being public sector employees, also think it is important that companies act in a responsible way when it comes to tax. Climate change is also taking up much of the agenda and we have to be strong with our message there, but we cannot let it crowd out other factors with a more social dimension. All funds seem to agree on climate issues now, but making an impact on other social issues and maintaining a reasonable return is very difficult, although it is something that we are very focused on. ■

Equity factor investing:
AN EVER-EVOLVING JOURNEY

Sponsored by:

BNP PARIBAS ASSET MANAGEMENT

Our panel of experts looks at what equity factor investing means for portfolios today, how different factors have performed amid the recent turmoil, and what the future holds for factor-based strategies going forward

Chair:

DANIEL MORRIS
Chief Market Strategist, BNP Paribas Asset Management (BNPP AM)
Daniel is chief market strategist and co-head of the Investment Insights Centre at BNPP AM. His experience encompasses advising clients and providing investment recommendations, as well as offering a strategic perspective to senior management and portfolio managers. Daniel previously held senior roles at TIAA-CREF, J.P. Morgan Asset Management, Lombard Street Research and Bank of America Securities.

Panel:

STEVE ARTINGSTALL
Investment Director, Alternative Risk Premia, Railpen
Steve has been with Railpen since 2008 and is currently investment director, alternative risk premia, leading a team of PMs and data analysts that manages £10 billion of global equities. He has been an equity analyst, portfolio manager and fund research analyst/ fund-of-funds manager in a career spanning 25 years in investment management. He has a BSc. (Hons) in Human Geography & Economics from Loughborough University and is AIIMR.

RAUL LEOTE DE CARVALHO
Deputy Head of the Quant Research Group, BNPP AM
Raul has 19 years of experience in the financial industry and has been deputy head of the Quant Research Group at BNPP AM since 2017. This team is present in Paris, Amsterdam, Hong Kong and London and centralises the research and development of quantitative strategies for all investment teams managing equity, fixed income and asset allocation portfolios. Raul has held a number of positions at BNP Paribas, joining the firm in 1999.

SNÆDÍS ÖGN FLOSADÓTTIR

MD, EFIA pension fund

Snædís is the managing director of EFÍA and LSBÍ pension funds and the operations manager of Lifeyrisauki supplementary pension fund. She has worked in the asset management sector in Iceland for the last 10 years. She is also chair of the education committee of the Icelandic Pension Funds Association. Snædís holds a degree in industrial engineering from the University of Iceland and a brokerage licence from the Ministry of Finance and Economic Affairs in Iceland.

BEN MATTHEWS

Head of Equity Research, Isio

Ben is the head of equity research at Isio. Isio, formerly KPMG's UK pensions practice, launched in March 2020. His responsibilities include coverage of equity manager research and selection, whilst also dedicating a portion of time to ongoing client management. Prior to working at Isio, Ben worked at Exane BNP Paribas as an equity research analyst in the telecoms sector. He holds an MSc in Finance and Investment, and a BSc in Business Management.

IAN NAGLE

Senior Investment Consultant, Mercer

Ian is the head of wealth consulting for Mercer Denmark, and has been a senior investment consultant with Mercer for over 10 years. Ian leads Mercer's investment strategy, client value proposition and relationships in Denmark and believes in innovation and co-creation, ensuring that Mercer Denmark continues to grow its investment footprint in the market. Ian holds a Bachelor of Commerce degree from University College Dublin.

ANDREW PEACH

Associate Partner, Aon

Andrew is a client consultant within the Aon investment practice and also heads up the specialist factor investing team at the firm. Andrew first joined Aon in 2012 as a senior investment consultant, and prior to this was involved in investment consultancy at Bluefin Corporate Consulting. Andrew regularly attends client meetings, industry events and roundtables, and is a regular contributor to the UK and European pensions and investment press.

JAMES PRICE

Senior Investment Consultant, Willis Towers Watson (WTW)

James joined WTW's manager research team in 2006, researching a wide range of asset managers and investment approaches. James also works with asset owners helping them construct portfolios or designing bespoke strategies. James is also a researcher at the Thinking Ahead Institute – its purpose being the mobilisation of capital for a sustainable future. James graduated from Imperial College London with an MSci in Physics.

RAMON TOL

Fund Manager Equities, Blue Sky Group

Ramon is a senior fund manager (equities) at Blue Sky Group, which manages the pension assets of KLM. He joined the group in February 2000 as a quantitative analyst in the performance and risk department. Ramon was responsible for setting up and implementing the manager monitoring and selection process at the group. He holds a master's degree in Economics with a specialisation in international financial economics and investment theory.

Chair: What are the panel's experiences of equity factor investing, and the recent appreciation of performance versus expectations?

» **Matthews**: Factor investing is a relatively new phenomenon for our clients. About a year ago, we started to really educate our clients on factor investing as we were getting a lot of questions on the topic. We also spent time trying to understand factor strategies and what they could mean for our client base. To date, and this is mainly due to recent under-performance, we have seen limited appetite for factor-based strategies.

Most of our clients generally have market cap exposure and that would be split between global and emerging markets in some cases. Generally, we've seen the governance budget for asset allocation being allocated elsewhere in the portfolio as opposed to making refinements to their equity portfolio as it stands. With the recent underperformance in value/size, for example, factor investing as a strategy has been a difficult conversation and a hurdle for our clients to overcome, but we've certainly had some interesting discussions along the way.

» **Peach**: We have been having these conversations with clients for several years now and, generally speaking, the appreciation of factors, what the factors mean and the investment rationale behind factor investing has gone down well, especially for those clients that have got market cap. Some investors who have made the switch, however, have been stung in the past 12 to 18 months by factor performance, so we've also done a lot of digging under the bonnet to help clients understand what's been going on.

Thinking about expectations, when you actually look at how the factors themselves have done, some have done better than others, but they have performed how we would have expected them to, given the set of circumstances that we had.

If we have that conversation with clients, generally they understand that. So yes, there has been a period of short-term pain, but it has been in line with expectations.

» **Flosadóttir**: It's important to look at the performance of the different factor investing styles, compare them with their relevant benchmarks and how we believe they should have performed given the situation faced in the last year, and the weights applied on different styles within the portfolio. If we look specifically at quality, growth and global value performance in 2020, they were in line with expectations given the economic and market conditions this year. The growth style did quite well, outperformed the benchmark and delivered, all in all, a good result for us. Value, on the other hand, did not do as well, but it is important to look at the broader spectrum here – it underperformed compared to MSCI but, compared to its benchmark, the value index actually outperformed.

When comparing these two styles it´s also important to keep in mind that, in the last years, the FAANGs have been leading the growth performance; and the low-interest rate that we have seen in the last year has complemented growth style better than value.

I would add also that, when you are a pension fund and you're investing for the long term, it's important to communicate to both the board and your members that you have to look beyond one-, two- or even three-year performance. And one of the key elements of diversification in the portfolio is that different asset classes do not behave in a synchronised manner, so different results within each year should be expected.

» **Artingstall**: Our experience of factors goes back at least 10 years. We started with the low volatility (low-vol) factor and then diversified into other factors. Our experience over that period has been positive. That's less obvious when you look at the raw returns. The past 10 years have been a strong period for market cap returns for the index so, low-vol in particular in the last couple of years has struggled to keep up.

But we know that factor strategies generally do better in weak market conditions than strongly in rising market conditions; and that's particularly true for low-vol, but also true, to a degree, for most other factors too. Quality and momentum have done fairly well in recent years. Value has struggled as well as low-vol, so those have been the main drags on factor-based strategies.

We don't have size as a specific factor that we target, but any factor portfolio that you build tends to underweight the mega cap stocks, so we already have a bias to that; and we have been looking at size, or at least the efficacy of factors in the smaller cap universe.

» **Chair**: How did returns compare to your expectations?

» **Artingstall**: Generally, our returns have been in-keeping with our expectations and it's just the last couple of years where it's been particularly difficult due to the strong market environment – bizarre when you consider that we've been through a pandemic, but the markets have been strong.

The value factor has clearly been struggling for many years and there are a lot of potential reasons for that but, on the flip side, growth stocks have been doing very well. Growth isn't necessarily just the inverse of value i.e. expensive stocks. There are other characteristics, which can be identified as specific to growth rather than just valuation, but it is interesting that growth has done so well considering that, historically, it's not been seen as a factor in the academic sense as one that should be included.

The Fama/French history, for example, hasn't included it and, again, growth is then lumped in with 'expensive'; but in the past few years we've seen these mega businesses, the FAANGs, which are very large and have this sort of scale advantage.

A lot has been written about flywheel economics in Amazon etc and we've seen these big companies evolve and disrupt the corporate ecosystem since they've had this ability to grow on small amounts of capital relative to the amount of profits they seem to be able to generate. It's been a challenge to conventional economics about scale diseconomies and it's also distorted the market environment to a large extent because other companies that maybe don't look that attractive can be bolted on to these bigger businesses and they can make huge returns from them by leveraging their digital platforms.

Performance disparity

» **Chair**: Investment performance of quantitative factor-based strategies has been varied. What do we believe are the reasons for that variation in performance?

» **Leote de Carvalho**: Multi-factor investing is based on a number of bricks which include the value, quality, momentum, low-risk and small cap factor investment styles. Clearly they don't have the same performance and, in 2020 in particular, value and small cap performed poorly. So, if you had more allocation to the small cap and to the value factors, you are likely to have had poorer performances than if you were more exposed to quality and momentum in your factor approaches. That's one of the reasons that can explain differences in performances for different multi-factor approaches.

A second reason that can also make a difference is the choice of the factors themselves that go in each investment style. Not everyone uses the same factors, for example, for value, some use price to book, others don't. That can make a difference; also, whether you diversify more or less when you construct your individual factor styles matters.

Another reason that can make a difference relates to how you actually construct each investment style once you have selected the factors that go in each of them. In particular, whether you neutralise sectors or not. Some do neutralise sectors, others don't. If you look at value in particular, this can make a huge difference. If you do not neutralise sectors in the value factor, you may be looking at poor performances since 2007. If you neutralise sectors, you probably were quite happy until 2019 and you enjoyed good performance from the value stocks from each sector. So, that can also make a difference.

Finally, those who take more tracking error can get better performances in good times.

» **Chair**: What is the panel's interpretation of what has gone on over the last couple of years?

» **Matthews**: Large cap technology has been the place to be. It has delivered, and that has fed through into client discussions. As well as that, the longer-term thematic plays have been appreciated by the market, more so than traditional value names.

When we consider factors such as value, there are obvious reasons for that underperformance and reasons that can be easily understood.

When considering performance, though, we've got to be mindful that single factors such as value, such as size, can underperform under specific time horizons and it is important to make clients aware of that. In fact, we prefer to have an allocation that is balanced and to be diversified. But the key point is to not be overexposed to individual single factors.

» **Peach**: We also prefer a balanced approach to factor investing. We've done a lot of analysis of performance to help clients understand what's been going on. Yes, the factors matter and the definitions of those factors matter to a degree but, no matter which way we sliced it, what has dominated has been the index construction – the diversification. Not being exposed to the very biggest stocks that were mentioned earlier can make a huge difference.

"We prefer to have an allocation that is balanced and to be diversified. The key point is not to be overexposed to individual factors"

We provide attribution waterfalls of what's caused the performance in the past 12 to 18 months, and index construction clearly dominates because that is felt across your entire portfolio. If you're running a balanced portfolio, your definition of value, for example, is only one part of that particular piece. Articulating that to clients has been key – helping them to understand that index concentration is a risk that we want to diversify against, and that concentration risk has continued to grow over 2020.

With a blank sheet of paper, would you be investing 15 per cent of a balanced portfolio in five stocks right now? The answer would be no. We didn't think it was the right answer at 10 per cent. We certainly don't think it's the right answer at 15 per cent. So, yes, definitions of factors can make a difference, but that's dwarfed by the index construction methodology element; and those products that maintain a link to the market cap as their starting point of the index will have done better in the past 12 to 18 months than those versions of multi-factor or factor investing that break that link and go for a more diversified approach.

» **Flosadóttir**: Factor-based investing has its ups and downs and there are periods of time where specific factor premiums such as size and value will experience underperformance relative to their counterparts. Performance of value and small cap has been poor, and the different use of factors and different combinations can havea large impact as well as neutralising sectors.

But, there *should* be a difference in performance based on styles. That's why we choose them; and why we emphasise the importance of a diversified portfolio, not only when it comes to bonds and equities, but even more importantly when it comes to investment styles, factors, sectors etc. The cyclical nature of factor-based investing is also an important note to keep in mind.

Value

» **Chair**: There has been much debate about the value factor, its performance versus growth, and its relevance as a factor – what are the panel's views?

» **Price**: Value has certainly been a huge topic of discussion: is value going to work? Why might it not be working? It's almost acted as a case study as to how a lot of the things we have talked about today have come together. Depending on an asset owner's portfolio, for example, they may have exposure to only value, in which case, the poor performance of value will have been a real issue for them. Alternatively, they may have value plus exposure to other things and, hopefully, a number of the other things have done well in that same time period. In that case the discussion is around the challenges of being diversified across lots of things – i.e. that you're portfolio is never the best, but hopefully it's never the worst.

The key point is that we need to ensure asset owners are thinking about their portfolios in the round.

With value in particular, while it hasn't worked and performance has been poor, in our view none of the explanations that have been put forward as to why it's done badly are particularly strong. In that sense, it's not obvious that there's something to fix; and that suggests that we need to hold on.

Our perspective on that thought is partly informed by a lot of the academic work that we see which focuses on book value. A lot of the other value metrics have done pretty poorly too, so we can poke holes in book value for not including intangible assets and things like that, but why has price to sales also done poorly as well? Or, why has price to cash flow done poorly? It's certainly a tricky one, and broader than any particular metric being a poor measure of asset value. That said, it's also not obvious to us that value is more attractive now than it was before, just because it's cheaper.

There are lots of good reasons why some of these companies that have become more expensive arguably should be priced at a premium; and therefore, should we assume that all valuations are going to return to where they were before? It would be nice, if you are a value investor, but it's not obviously the case that it will happen, or that it should happen.

So while value has done poorly, we should be careful about assuming that, because it's done poorly, it's either going to do really well in the future or that it's going to keep doing poorly.

» **Tol**: Value hasn't been working for quite a long time, and that raised some issues internally and even some clients have asked about it. To give you an example, in our global small cap portfolio, we have a deep value manager. Last year, they underperformed the core index by 1,200 basis points (bps), so that raised a lot of questions internally.

"The key point is that we need to ensure asset owners are thinking about their portfolios in the round"

We had a growth manager sitting alongside that, and they outperformed 1,600 bps. I made clear that the two managers operate "in tandem". In case we were to consider terminating the value manager, we should consider terminating the growth manager as well, because otherwise our manager mix would no longer be style neutral (which we strive for).

I am quite interested in exploring the question of whether or not value can be improved by including intangibles. Some people say you can only slightly improve your risk/return relationship by doing so, others argue that adding intangibles improves the value factor significantly. We are fortunate that the value manager we have in place does include intangibles, and they believe it did add to performance.

But it has been extremely difficult because value has been underperforming not for five years, but for a much longer period of time. YTD 2021, the performance of the aforementioned managers is the opposite of what it was last year. Again, you need to look at the manager combination.

Eventually, it all comes down to communication – properly communicating both internally and externally and stressing that we are in it for the long run. Also, a balanced, style diversified approach is crucial to a successful active manager portfolio.

» **Leote de Carvalho**: The actual impact of intangibles can be difficult to estimate and, from sector to sector, can have quite different impacts. Therefore, what we tend to do, is to control for sectors – and we try to compare companies that are more easily comparable with each other. Intangibles can be important in the tech sector but if you compare tech to tech, they all have intangibles and then the question becomes less important.

Our experience with sector neutral value investing has been quite positive. We saw very good performance from our sector neutral value style from 2000 until mid-2018, with just a blip in 2009. The reason for this good performance is that we control for sectors. However, despite the fact that we control for sectors, value stocks performed poorly in 2019/20, and indeed, irrespective of whether we use price to book as a value factor or not, all value factors performed poorly since 2019. But we found exactly the same in the tech bubble in 2000.

What we have also found is that the period that tends to be favourable for value investing is a period where the dispersion of value metrics remains relatively constant or actually compresses. Value is about investing in cheap stocks and you expect the price to converge to fundamentals; and you move away from expensive stocks because, there, the stock has to perform poorly for the valuations to converge with those of cheaper stocks. However, there were periods in time when value spreads expanded. The tech bubble is an example and 2019/20 offers another example.

In fact, value spreads today are at the same level as at the peak of the tech bubble. So, we believe now that we have ahead of us quite a favourable period for value stocks because it's much more likely we will see a value spread compression than a value spread expansion as it happened immediately after the tech bubble.

» **Tol**: Can we talk about growth? A number of years ago, MSCI revived its growth factor index claiming there was sufficient evidence for growth to outperform in the long run. I am sceptical, but growth has performed well over the past couple of years and I've seen some quant managers looking into the growth space to add it as an additional long-term factor.

» **Artingstall**: Growth has been dismissed possibly because it came with too much baggage. Growth stocks have historically been associated as being the opposite of value. i.e. if it's expensive, it's a growth stock and that's a bad thing because it's going to disappoint. They also tend to be volatile, so maybe there's too much positive sentiment about them at the moment. Everyone's jumping on the bandwagon – although that could be momentum which is potentially a good thing, but not if it's too much.

The work I saw by MSCI essentially had tried to strip away some of these other factor exposures and look at the residual growth factor and they were highlighting that it was a positive factor when you excluded all these other negative contributors to a growth factor portfolio.

It makes sense – if you can access portfolio companies that have illustrated the ability to grow faster than their peers and they're not expensive, and you can avoid overpaying for them, then that seems to be a positive attribute. Why would you want the opposite? Why would you want a portfolio with terrible growth? Maybe you'd buy them if they were dirt cheap, that's the value idea, but then you have this headwind that they're cheap, but they're not growing at all. They're growing very slowly, so maybe they're priced correctly anyway. They are cheap for a reason.

There's always this interaction between factors and it's very dangerous to take a narrow view on something with a monovision and ignore other effects that also have an impact on the return situation.

Growth is also linked to the quality factor. Companies with high returns on capital should grow faster and arguably it's also linked to the idea that if you've got a high return on capital, you should be investing more than your depreciation rate. You should be over investing in the business to grow faster to benefit from the high returns on marginal new capital.

» **Leote de Carvalho**: To pick up on that, we don't have growth explicitly – we have quality. Quality did extremely well. Quality was really the counter lever of value in our approach. We saw an absolutely fabulous performance of the quality factor last year.

» **Flosadóttir**: One point that hasn't been raised concerning the growth factor is interest rates. The low interest rates that we have seen in recent years tend to complement growth style better than, for example, value. We saw this recently. If you look at just the past three months, when interest rates turned up a little, we saw an immediate effect – value went up and growth went down a little.

However, when you think ahead, how optimistic can we be that interest rates will go up more than just for the short term? Given the increase in savings and the change in demographics, in the long run, when it comes to money and savings, it will be a matter of supply and demand. This is eventually likely to keep interest rates rather low, which will fuel the growth sector even further or at least make room for its continuum.

» **Matthews**: The point around including growth as a potential factor is interesting and we'd be supportive of seeing developments in that field, mindful obviously that the overall portfolio should be tilted towards the factors that are going to add value as opposed to having something which looks a bit more like the broader markets.

Regarding the interest rate discussion, it will be interesting to see how the market evolves over the next year; what the reopening trade means for the broader market and what it does to rates as we see businesses recover in beaten up sectors.

» **Peach**: It has been tough for value and that has highlighted why we need a balanced exposure to factors.

Value investing is characterised by long fallow periods and potentially short periods where investors can 'fill their boots'; that means it requires discipline and therefore value is often the factor that gets a hard time. As soon as factors/multi-factors aren't doing well for whatever reason, value gets the blame without possibly understanding the nature of what it means to be a value investor for the long-term.

We've noted the value spread is at historic highs, but from that we should not assume that it's going to be a 'fill your boots' period for value. As has been mentioned, the trajectory of interest rates is not clear.

But we also need to consider what's driving the wideness of the value spread. Back in 1999/2000, a lot of stocks were very expensive and possibly without merit, and value snapped back. That's not really the case this time. It's more on the cheap side. It's that cheap stocks are depressed rather than lots of stuff being overvalued. So, we don't think there will be a snapback, but we do see the conditions for value to do quite well.

On the point about lack of valuation support, that comes down to how you frame your value, in terms of how you use the value score to allocate to value. If you use your value score to allocate to the factor, you will end up with the very cheapest stocks and you run the greatest risk of allocating to companies that are actually cheap for a reason. So, even within factor exposures, diversification is key.

» **Nagle**: One other point to mention is that, as we transition to lower carbon investments, it's going to present some structural challenges for value investing. Traditionally, those types of companies are more carbon intensive than the stocks we've talked about under growth.

At Mercer, when we're looking to build our active equity portfolios, we believe it's important to include a range of risk and return drivers and style is one of the lenses we use to ensure that we are blending complementary managers together within our multi-manager funds. So when we think about style, we would consider our exposure to value but as part of a diversified portfolio taking into account quality, momentum, size and low-vol too. Value shouldn't dominate the portfolio but neither should any other factor and, looking ahead, we believe that value can provide some element of diversification to the styles that we discussed that have done well over the last decade. We certainly still feel value has a role to play but the backward-looking systematic strategies, particularly in index form, may face the most challenges in the years ahead.

The low volatility factor

» **Chair**: The low volatility factor performed really well during previous crises, but not as much in 2020. What are your views?

» **Nagle**: For the reasons I just mentioned, we believe in allocating to a range of factors as part of a well-balanced, diversified portfolio and low volatility should form part of that. When you look back over the last decade, low-vol has done well. It's delivered the objective of lowering absolute volatility but also producing long-term outperformance versus a broader market. At the beginning of 2020, some level of protection was provided versus equities overall but not to the same extent as in previous crises.

A large part of that was due to the nature of the shock to the markets as a result of the pandemic and the fact that the impact on the global economy was so unprecedented – stocks in some traditionally more defensive industries sold off quite heavily.

In terms of low volatility as a factor, it's an important part of a diversified portfolio. Actively managed low volatility strategies would be our preferred approach versus a passive index-based approach because of the risks that are inherent in low volatility equity, particularly around interest rate sensitivity and valuation. We think that active managers are better placed to mitigate those risks going forward as well as incorporate ESG risks into their investment process.

» **Leote de Carvalho**: BNPP AM research has shown that low-vol stocks continue to have higher sharpe ratios than higher volatility stocks, at least until last year. 2020 was a year when the premium was not there. It's not the first time, but it was unfortunate because there was a short period of very strong market underperformance and it would have been good to have that low volatility anomalous premium.

The period I reference however was extremely short because actually, 2020, for most of the year, if you remove the five/six weeks starting in mid-February, was a very positive year; there was just a big drawdown in late February and March. For low volatility stocks, even if they have higher Sharpe ratios, when markets have very positive performance, the fact that you have low beta makes it difficult.

2020 was a combination of the fact that the alpha was not there; the fact that, if you remove those five/six weeks of very negative performance in late February and March, the markets actually had very positive returns; and finally, the fact that the very mega caps significantly outperformed. If you really invest only in low volatility stocks, most likely you had a large underweight on those very large cap stocks and that also didn't help. So, low volatility strategies really had a difficult 2020 for those reasons.

» **Peach**: The global financial crisis (GFC) was triggered by a very specific set of circumstances that were not remotely the same as what we experienced last year. During the financial crisis, liquidity dried up, there was very clear shock to the equity market and, to a degree, a flight to quality; so government bonds did well and bond proxies, essentially low-vol stocks, did well during that period.

The sell-off last year was pretty indiscriminate. Following that, we saw a very strong market afterwards; but that was driven by a very narrow set of very large growth stocks. If you put those things together, it's not that surprising that low-vol hasn't done very well in 2020. For the sharpe ratio reasons that have been mentioned, we also still think it warrants a place in the multi-factor portfolio and we are certainly supportive of it going forward.

» **Artingstall**: I agree that the market sold off in aggregate heavily in 2020, but I wouldn't say it was indiscriminate. I'd actually say it was extremely discriminate in that certain stocks and sectors got hammered. Anything in the leisure and hospitality sectors, anything to do with retail, such as shopping centres, got hammered. We all know the sort of stocks that have suffered immensely.

Equally, the market was highly discriminating in bidding up the beneficiaries of the Covid-19 pandemic. For example, all the tech companies that allowed us to do video calls and so on. So, in that respect, there were some extreme polarities in what was going on in the market. Low-vol didn't benefit from that – it was probably a net sufferer from those effects.

Low-vol tends to prefer the quieter backwaters of the stock market and those quieter backwaters are normally a good place to be in a crisis, but in a crisis like a pandemic, it didn't work out that way. It was different and there were clear reasons why low-vol didn't work so well.

The real question for low-vol is whether or not you leverage it up or leverage adjust, which obviously people tend not to do given it's a bit difficult to do that for pension funds.

» **Matthews**: We have mentioned 2020 and, in a sell-off, it can almost be hard to stomach when you employ a value and low-vol strategy or you have a tilt to those particular factors, and you end up doing quite poorly and you see clients where they've got growth exposure doing a lot better. We had a lot of interesting discussions around that and it's understandable how it's hard to stomach, but the key point here is that, given it was a pandemic, it was a different situation to consider for clients; and the point around growth having better upside capture but also seemingly better downside capture as of late was more of an education piece. We still believe that the academic findings of the low-vol factor are undeniable and, over the long-term, we believe that the return premium is still there and it still remains, as part of a balanced strategy, a key aspect of what clients should be considering.

» **Tol**: Our clients have been investing in low-vol since April 2010. Last year, it was hard when clients found out that their low-vol portfolios didn't help them. But there were very strong polarities in the markets. The typical low-vol stocks – energy, materials and so on – were hammered. That's what happened in March. But then, when the stock market rallied, rather than these stocks rallying the most, which was expected, the IT stocks in fact rallied even more than the typical low-vol stocks; so it was almost a double-edged sword for low-vol because the stocks went down the most during the huge market correction and lagged in the upturn.

In the long run, we still believe in this factor. It does exactly what we expect it to do – market similar returns, but with lower volatilities. One disappointing year for low-vol does not mean it has stopped working and there are no fundamental reasons why the effectiveness of the factor could have broken down. The only short term concern I have here is the interest rate sensitivity of low-vol.

» **Price**: We consider every low-volatility strategy to be active, whether it's via an index or not. We see that as important because it gets to the question of the design of a quant manager's low-volatility strategy or the design of the low-volatility index that is being tracked. It's important to understand what's going on inside the strategy.

There's a big difference between a portfolio that's maybe optimised to be low-volatility and has 200 stocks in it versus one that's tilting towards low-volatility stocks and has 1,500 holdings. If markets rebound with only a few stocks rebounding a lot, then the optimised strategy might own them, but it might not. You're then really into the specifics of the strategy and who designed it and what it is designed to do. It's important to review all these things, just as it is when investing in a value strategy, or any strategy.

Linked to that, we don't usually recommend clients use standalone low-volatility allocations within their equity portfolios, primarily because while it's an excellent approach if you're looking to reduce your equity risk in an equity portfolio, most of our clients are multi-asset investors and so the real question is not, 'do you want to have an equity portfolio with a beta of 0.7?'; it's, 'do you want to sell 30 per cent of your equities and what might you reinvest that into?' You could move assets into the corporate credit space or different parts of the

"Low-vol tends to prefer the quieter backwaters of the stock market, and those backwaters are normally a good place to be in a crisis"

credit asset class – some areas like alternative credit have very different profiles, albeit for some of those strategies last year's performance was not so good. Or you could invest in hedge funds and think about discretionary macro, CTAs and other strategies that, when equity or bond markets sell off, it's not a question of selling off less, it's possibly a question of making money for the overall portfolio.

Finally, when it comes to reviewing how various strategies have performed through 2020, it's interesting to consider whether or not we've actually seen the regime shift that we all think we've seen last year. Typically, when we think of a regime shift in markets, we think of large drawdowns like the dotcom bubble, or the GFC. These are often accompanied by sector rotations and that's where we see leadership change in factors and styles as well.

However, in 2020, while there was a sudden drawdown, we didn't really see that rotation in market leadership. We saw the sectors that had been performing very well in the time running up to it perform well during it and have performed well since.

In this market setting, yes we've seen a level of markets move up and down a lot, but actually we haven't seen that rotation. So maybe our expectation that strategies that worked before shouldn't have worked afterwards is a little bit off in this case. I think this rapid change in market level, and the repricing of assets positively or negatively affected by events, relates to the previous point about the market being quite discriminating and adapting quickly. 2020 wasn't like other crises. It wasn't a slow realisation with different parts of the market realising there were issues. It was quite abrupt.

ESG

» **Chair**: A big topic across all asset classes is ESG and how it is addressed within a balanced portfolio. As managers, BNPP AM is fully embedding this into its processes. How much consideration do you give this in your decision-making when choosing a manager? Could it become a stand-alone factor?

» **Flosadóttir**: Our pension funds all have ESG policies which we apply through the entire investment process where we put special emphasis on certain areas. A significant part of that process is evaluating the ESG policies applied by the fund managers during our due diligence process and follow-up from there. In recent years it´s rarely something that we need to start the conversation about as it has become an industry standard and therefore usually one of things that the funds that we are meeting with introduce and talk about first.

"One disappointing year for low-vol does not mean it has stopped working - the only short term concern is the interest rate sensitivity of low-vol"

Looking ahead, ESG scores and ESG will become more significant as a factor, but not necessarily as a standalone factor. I believe it would serve better being compiled with other factors as well. It is also important that investors understand how ESG investing can potentially lead to unintended factor tilts.

If we're going for ESG as a standalone factor, perhaps we could look at some impact funds that are strictly focusing on making an impact through ESG metrics. But in other equity funds, I think it will always be coupled with some other factors as well.

Applying ESG metrics throughout the investment process will gain momentum in the coming years and be of even more significance to investors, pension funds in particular. So, the evolvement of ESG as a factor or coupled with other factors will be an interesting progression to watch,

» **Nagle**: At Mercer, we believe that a sustainable investment approach is more likely to create and preserve long-term investment capital and that ESG factors can have a material impact on the long-term risk and return outcomes. For these reasons, it is fully integrated into our investment process.

In terms of ESG ratings, we maintain ESG ratings for over 5,500 strategies and we've incorporated ESG ratings into our research process since 2008.

To answer your question, if we are looking at managers for inclusion in a portfolio, we will always take the ESG rating into account and, if you had two strategies with the same prospect for performance, we would have a preference for the strategy with the higher ESG rating.

On the point of ESG as a standalone factor, historically, ESG indices have provided better risk adjusted return. However, standalone implies that it's looked at almost in isolation or separately and our approach is very much that it's at the core of our investment process, so it informs the investment decisions as a whole as opposed to being looked at on a standalone basis.

» **Peach**: We have ESG ratings for all of our funds generally and that ranges from recognising that it's either not taken into consideration, it's incorporated in the financial decision making or it's a bit further in the direction of impact investing.

When it comes to factors and multi-factors indices, it's trickier because it's systematic so you're relying on robust data, something that you can create a rule about. So it's not without its problems, but that's one of the reasons we favour focusing on where the data is more consensual, like with carbon emissions. When you go further into ESG, that's where it's more problematic because it's such a broad church and the ESG agencies themselves differ. There's not a huge amount of correlation between them so data there is a problem.

We employ ESG and climate considerations in tandem with our factor methodology, but the data is going to have to improve for this to become considered a standalone factor.

» **Matthews**: We incorporate ESG into our investment process. It's a key factor now. Any decision we make or any thesis that we have is underpinned by strong ESG ratings. Picking up on the point around the data providers, there would need to be a greater level of consistency between them to allow some more shared thinking on the underlying stocks. ESG is considered as a method of good stewardship so typically companies that are strong in the sense of ESG ratings tend to be quite strong companies from an underlying fundamental basis as well, so that can feed into the wider factor piece.

» **Price**: We expect investment decisions to be made using all relevant and available information. Whether that is data in the report and accounts or ESG data or something an analyst has read in a trade journal - all that information should be incorporated to make the best investment decisions possible. To that extent, ESG data, data vendors and so forth are a great source of additional information that's becoming widely available to financial markets and we would expect that to be priced in to markets over time. Therefore, it's important investors take it into account when making decisions.

I would argue that the disagreement, in terms of ESG scores and metrics, amongst the data vendors is a positive. If you're a skilled investor, you should be able to distinguish between the good and the bad, or the data points that are relevant and not so relevant, and that should help you generate stronger performance than your peers. From an active investor standpoint, having disagreement in a wide range of information is positive versus a situation where everybody agrees that company A has a good ESG score, and company B does not.

In that case the ESG information about companies A and B is probably reflected in the price already and therefore offers no competitive advantage. For asset managers, both stock pickers and quants, we think this is potentially a pretty rich area for them to demonstrate their abilities and gain a competitive edge.

» **Artingstall**: At the moment we are applying some exclusions for specific companies that are related to thermal coal and tar sands – the 'dirty' carbon intensity areas which seem to be sunset industries. It's hard to see them as being attractive as long-term investments and they are unattractive from an environmental perspective. It's difficult to apply a heavy screen since that could screen out a lot of companies and it also depends on whether you do it absolutely or relatively. If it's absolute, then you're significantly reducing your exposure to utilities, energy and materials as those are the three sectors that account for about 80- 90 per cent of carbon exposure. Then you have level one/ two/three emissions which further complicate matters.

Lastly, what if you are looking at a company that is bad at the moment but has a great plan to evolve into a far less carbon intensive business model going forward? Rather than avoid these companies, should you not be engaging with them, because you may well benefit in the future from owning such companies which are evolving in a positive way.

» **Leote de Carvalho**: We have a company-wide ESG scoring system which is sector specific, and which is inspired by the Sustainability Accounting Standards Board (SASB) framework. That scoring system is what we use in our quant approaches and we found that our ESG scores are actually exposed to quality and low-risk factors. We find that natural and we are quite comfortable with that finding – it is backed by academic research and it is also helpful for our quantitative equity approaches because we tend to be exposed to quality and low-risk anyway.

So we chose to use an integrated approach and we use portfolio optimisation to control for the ESG factor exposures. That's also because our products meet certain criteria from ESG industry labels, and we find that using optimisers to make sure that we always meet those standards is the easiest. We're quite comfortable because ESG is aligned with the type of factor exposures we have in our quant equity multi-factor approaches so it works.

» **Morris**: To conclude, there are certainly a number of key takeaways from today's discussion – diversification remains essential in European pension portfolios, and the multi-faceted nature of equity factor investing means it continues to play a dynamic and highly useful role in pension portfolios today. ■

PODCAST

How the U.S.'s robust securities law can benefit European investors

Over recent years, several financial scandals have shocked investors, such as the Danske Bank money laundering case. When a scandal like this occurs, investor returns suffer, which is why many seek redress. Many European investors seek to recover assets lost as a result of securities fraud through U.S. courts, with their robust securities laws.

In this podcast, Jeremy Lieberman, Managing Partner at Pomerantz LLP, talks to *European Pensions* Editor, Natalie Tuck, about how European investors can use U.S. courts to recover assets lost to securities fraud and the challenges facing investors seeking compensation

Jeremy, can you begin by giving a brief overview of why European investors are turning to the U.S. to recover assets lost as a result of securities fraud?

The answer is mostly economic. Over the past decades, European investors traditionally eschewed the U.S. legal system because they found it to be too aggressive. They didn't like the litigious nature, they preferred to 'engage' rather than litigate. It does sound good on paper but in reality there were losses incurred as a result of securities fraud, which is a natural part of the market, unfortunately. Institutional investors started to see their U.S. counterparts receive compensation from the *Enron* scandal, the *WorldCom* scandal and, later from *Petrobas*, which ultimately compelled European institutional investors to engage in securities litigation.

Pomerantz has been in the vanguard of finding ways for international investors to use the United States' robust securities laws to recover assets lost as a result of securities fraud. Were there cultural barriers to overcome to interest European investors in participating in litigation in the U.S.?

Absolutely, there were cultural barriers and there still are cultural barriers. A lot of institutional investors, particularly European, don't want to put their head above the parapet. If you are a trustee or a board member of a pension fund, often one of your key objectives is to avoid embarrassment. Pensions, to some extent, are perceived as a boring business and your job as a trustee is to make sure things remain boring: that the returns are solid and the beneficiaries get the money that is due to them. That's the model, so to do something more aggressive that puts the institution's or pension fund's name out there is something that a lot of trustees and board members do not want to face.

Litigation is, by nature, a confrontational exercise. Some of that stigma has eroded over the years as a result of larger settlements – such as the US$3 billion Petrobas settlement, which greatly benefitted institutional investors. The potential embarrassment for pension funds now might arise from not getting involved and missing out on compensation. Therefore, there is this dual pressure: on one hand, they want to keep a low profile and on the other hand, they don't want to miss out on opportunities for compensation they are entitled to.

What are the legal challenges facing European pension funds that hope to recover assets through litigation in U.S. courts?

The main legal barrier is a 2010 decision by the U.S. Supreme Court, *Morrison v. National Australia Bank*, which held that if you purchased your shares on a non-U.S. exchange, i.e. on the London Stock Exchange or on a European Bourse, then you are not entitled to recover assets under the federal securities laws. That really changed the game for a lot of investors because, prior to that decision, in a case like *Vivendi* or others that had a large international base with a U.S. component to the fraud, the U.S. courts would certify classes of non-U.S. investors and include them in the case. After the *Morrison* decision, the courts would not include these institutional investors in cases unless the assets were purchased on the U.S. exchange.

Are there instances where it is preferable to litigate securities cases in European courts?

I think it is always preferable to have the case heard in a U.S. court and to find a reason why the court should want to include the non-U.S. shares. That should be the first option. Obviously that is challenging, though, under the *Morrison* decision. However, there have been successful outcomes in non-U.S. jurisdictions, such as *Fortis* and *Olympus*, and currently there is the *Volkswagen* case proceeding in Germany, among others.

These successes, however, are to a certain degree tied to the *Morrison* ruling because, even before *Morrison*, you could only bring a case in the U.S. if there was a U.S. nexus to the fraud. If there wasn't a U.S. nexus to the fraud, investors would tend not to do anything. Morrison raised a lot of questions for investors: Why are certain classes of investors being treated one way whereas others, based on where the securities were listed, are treated another way?

The *Morrison* ruling was an effort to really pare down class actions and securities litigation but it actually created a very large mechanism for securities litigation outside of the U.S. As a result, corporations are now defending large claims outside of the U.S., which they may not have had to do prior to the *Morrison* ruling.

Are American courts sympathetic to claims arising from ESG disclosures?

Not quite yet. For example, the *Exxon* case, that centered on its environmental, social and governance (ESG) disclosures, did not succeed, despite it being a pretty formidable case as far as the facts went. Now the U.S. Securities and Exchange Commission (SEC), under a new administration, is trying to put in rules and regulations requiring disclosures related to ESG. There is more focus and I think you will see more cases related to it but we're a long way from seeing any real monetary recovery for investors as a result of ESG issues. Already class actions are quite controversial, so adding an ESG issue, which on its own in the United States is somewhat controversial, particularly when it comes to aspects like financial disclosures, is mounting controversy upon controversy.

How has the global legal landscape changed since you started practicing? Can you predict any future trends?

The global landscape has changed in that a lot of significant institutional investors are now seeing that, whether they want to be confrontational or not, whether they want to put their names out or not in these lawsuits, it is a fact of life that there are going to be situations that occur where a company has not been completely forthright with its investors. That creates a problem, which requires a resolution. You have a right to a claim and if you haven't exercised it, that is not only a moral problem, that is an economic problem. I think every large institutional investor understands that now. That has led to influential institutional investors getting involved, such as the Universities Superannuation Scheme in the U.K., which became the lead plaintiff in the *Petrobas* case.

I think despite a cultural reticence it's becoming an economic reality and a fact of life. The question will be how do these cases in different jurisdictions become consolidated. If there is a case in Germany but for the U.S. shares there's a separate U.S. case occurring, there may be contradictory rulings and contradictory recoveries, where in one jurisdiction you'll have a substantial recovery for investors and in another jurisdiction you'll have zero or a very miniscule recovery for investors. It makes very little sense. What I predict will occur – and I don't know how long it will take – is that at some point there will be a consolidation of these lawsuits in one forum. This could be where each jurisdiction agrees to have all the securities heard under one roof, whether it be in New York, Brussels, London or anywhere.

You are used to frequent travel across the globe to meet with institutional investors. How has the pandemic affected how you interact with clients and potential clients?

I don't want to sugar coat it: I would say poorly. Certainly, ongoing matters with clients, where they're already engaged in the case, have been facilitated by Zoom. However, a lot of our efforts have been educational and about meeting clients, developing relationships and explaining the process to them. That type of contact has been lost, so the ability to engage new investors or to increase the appetite has been hurt by the pandemic. We hope the doors will open again so we can educate institutional investors on how these lawsuits have a critical impact on their balance sheets. ■

COVID-19 IMPACT

A contribution crisis?

With a report from EIOPA suggesting that pension contributions have decreased as a result of the Covid-19 pandemic, Natalie Tuck **looks at the impact on pension contributions across Europe and whether there are any long-term consequences**

WRITTEN BY NATALIE TUCK

First and foremost the Covid-19 pandemic is a public-health crisis, but there is no doubt of the economic crisis that the coronavirus has brought with it. Countries around the world have taken drastic action implementing multiple lockdowns since the beginning of the pandemic to try to supress the spread of the virus.

With this, unfortunately, jobs were lost or put on hold and many companies struggled to survive. But what did this mean for pension contributions? A report published by the European Insurance and Occupational Pensions Authority (EIOPA), in January, noted the "direct impact" on people's personal finances caused by the pandemic, which may have already had an impact on pension contributions.

Eleven out of 22 member states that provided EIOPA with information indicated that in their jurisdictions, decreases in contributions were already being observed. "While it is too early to draw conclusions, also considering most member states do not yet have granular information, lower contributions appear to be affecting both personal and occupational pension schemes," the report noted.

This is due to several reasons, EIOPA explained, such as employers delaying contributions in light of measures put in place in different member states to ease the burden on businesses; savers delaying payments, taking advantage of forbearance measures put in place to limit the impact of the crisis on their finances; and employers' and/or savers' lower contributions because of the increase in unemployment.

Geographical differences

Europe is not homogenous and while some countries witnessed a big impact on people's ability to contribute to their pensions, others were less affected. For example, there is a stark contrast between Ireland and the UK, in which the latter has broader occupational pension coverage through its auto-enrolment policy.

Irish Association of Pension Funds CEO, Jerry Moriarty, says a survey of its members last year showed there had been little or no impact on pension contributions. "That's probably not a huge surprise as sectors that have high occupational pensions coverage were among those least impacted by Covid-19 – public sector, financial services, pharmaceutical, science and IT. The areas that had the most negative impact tend to have low pensions coverage – retail, hospitality and tourism."

However, he highlights that the pandemic has delayed the roll out of auto-enrolment in Ireland, so it has prevented those that are not already a member of an occupational pension from being able to contribute one.

The UK, on the other hand, which completed its auto-enrolment roll out several years ago, saw member contributions plummet by 11.2 per cent between the first and second quarters of 2020, according to figures from the Office for National Statistics (ONS), falling from £1.8 billion to £1.6 billion. During the same period, employer contributions fell by 5 per cent, from £3.9 billion to £3.7 billion.

Job losses in the UK and its Coronavirus Job Retention Scheme, which saw many employees in Covid-19 affected industries furloughed and on lower incomes than usual, contributed to this dip.

Similarly, EIOPA's report stated that in Iceland lower contributions were observed both in occupational pension and personal pension schemes as a direct consequence of increasing unemployment rates.

For other European countries, such as Finland and Belgium, contributions were affected as employers were granted the possibility to lower/defer contributions within a fixed period of time, but after this period has elapsed, those contributions must be paid, EIOPA said.

Finnish Pension Alliance manager (public advocacy), Janne Pelkonen, notes that in Finland, pension contributions for employers were lowered temporarily by -2.6 percentage points during the worst of the pandemic in 2020 from May until end of the year.

"The estimated cost from this supportive action towards employers was about €1 billion in total," he says. "This was in a sense a loan from the capital buffers of the pension system, as the contribution rate is going to be raised accordingly between 2022-2025. It was also possible for companies to postpone pension contributions for three months, but they have to pay 2 per cent interest rate from this postponement."

Not all countries have been as adversely affected, however. Commenting on the situation in Sweden, Skandia pension economist, Mattias Munter, says the country and industry experienced a shock last spring and many of Skandia's client companies prepared for the economic worst, looking to cut costs.

"There were also a lot of enquiries from smaller companies about temporarily pausing pension contributions. However, looking back at the whole of last year the effects on pension contributions were not dramatic by any means. We did see a decline in total premiums paid compared to a standout 2019, but it is more or less level with the result we had in 2018."

"Across Sweden, the contributions for occupational pensions actually increased by 4.7 per cent compared to 2019. That is probably a reflection of the swift recovery in economic activity supported by huge stimulus from the government and central bank," Munter states.

This situation was also seen in Denmark, according to Forsikring & Pension deputy director, Karina Ransby, with the level of pension savings in 2020 at an all time high.

"In the corona-year 2020, Danish citizens paid a record €17.7 billion into their pension schemes. This is great news, not only for pension savers, but also for the Danish economy," she says.

However, Ransby highlights that some industries in the economy have, however, been more affected than others. "The industries hit the hardest by the corona crisis and suffering most job losses are industries often associated with lower levels of pension savings," she says.

"Some of the industries most affected are hotels, restaurants and entertainment. We know from previous analyses that especially the hotel and restaurant industries are characterised by a relatively large proportion of employees not paying automatically into pension schemes," Ransby explains.

In Denmark, approximately 95 per cent of the workforce automatically pay a percentage of their salary into their pension schemes. While a few industries are characterised by less structured pension saving, employment has during the coronavirus crisis increased in sectors where obligatory pension saving is commonplace, she notes.

"The corona crisis has increased employment in the health sector. New jobs have been created to perform testing, analyses and vaccination. Generally, employees in the health sector are organized and pay automatically into pension schemes. This is part of the explanation why pension savings was at a record high in 2020," Ransby says.

Future prospects

Despite the pandemic not being over, already there is some positive news being reported on pension contributions. For example, the figures from the UK's ONS revealed that member contributions to private sector defined contribution (DC) schemes grew by 12 per cent between the second and third quarter of 2020, rising from £1.6 billion in

June to £1.8 billion as of September 2020, according to figures from the Office for National Statistics (ONS).

Public sector defined benefit and hybrid (DBH) schemes also saw an increase in employee contributions from £0.6 billion in quarter two 2020 to £0.7 billion in quarter three, although there was an 8 per cent decline in private sector DBH employee contributions.

Commenting on the figures at the time, Royal London pension specialist, Helen Morrissey, said: “After seeing a dip in employer and employee pension contributions in the last set of data it is encouraging to see the figures have bounced back.

“While this will be because less workers were on the Job Retention Scheme it is heartening to see the uncertainty caused by the pandemic has not caused people to turn their back on pensions by either stopping or slashing their contributions long term.”

For Finland, Pelkonen believes that a temporary drop in wages seen in 2020 might end up being “a rather small bump in the long-term finances of the earnings-related pension system”. He says that wages have recovered “fairly quickly” from the initial shock in 2020.

“Wage sum growth and economic performance are of course very important and in the long run 75 per cent of pension liabilities are to be covered from pay-as-you-go contributions in the Finnish model. It depends also on global and domestic growth prospects, which seem to be fairly positive after substantial recovery support following the crisis,” he explains.

In Sweden, Munter adds that there is still “a lot of uncertainty regarding the long-term effects” of the pandemic. Although Sweden doesn’t appear to have been as badly affected, calculations published by Skandia last September, found that the pandemic risks reducing future pensions by several hundred euros a month, depending on age and occupational group. The firm said people would need to make extra savings of between €47.22 and €297 per month to compensate for the effects of the pandemic.

Looking at Denmark, Ransby says that as the majority of the Danish population pay automatically into pension schemes through their employment, they will not suffer any long-term negative impact due to reduced contributions.

Whilst this is encouraging news, EIOPA’s report warns that risks relating to lower accruals may also emerge given that the low interest rate environment is expected to persist.

“Given the continuous shift towards DC schemes, which are mostly prevalent across the European Economic Area, the low returns coupled with the impact that (high) costs can have on returns, can have an important adverse effect on members’ and savers’ accumulations,” the report stated.

Therefore, it stressed that for member states where members and savers can access projections, it is important to ensure such projections take into account the impact of the crisis and the continued expected low interest rate environment to ensure they take informed decisions and plan accordingly. ■

Industriens Pension boosts low-contribution member savings

DENMARK’S INDUSTRIENS Pension has taken a step to help boost the savings of low-contribution members’ pension savings.

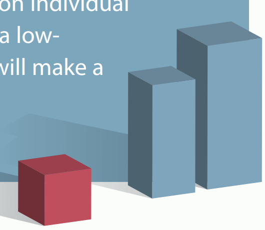
From 1 June 2021, members with contributions below DKK 800 a month will not have to pay for insurance, instead, all of their contributions will go towards saving for a pension.

A typical contribution to Industriens Pension is divided between savings and insurance. Industriens Pension head of press, Laurits Harmer Lassen, explains that for those with higher contributions there is a fair share going to each part and members will build up good solid savings.

“For those with very small contributions, however, it is different and the main reason why our owners (unions in The Central Organisation of Industrial Employees in Denmark and The Confederation of Danish Industries (DI)) started the pension scheme many years ago was for retirement savings, so we feel like we need also to prioritise that for those groups,” he says.

While the decision was not motivated by the coronavirus, he says the pandemic has made the pension fund’s decision even more important. Primarily, the decision came as a result of the changing labour market, which sees more people take on part-time or temporary work, as well as member feedback.

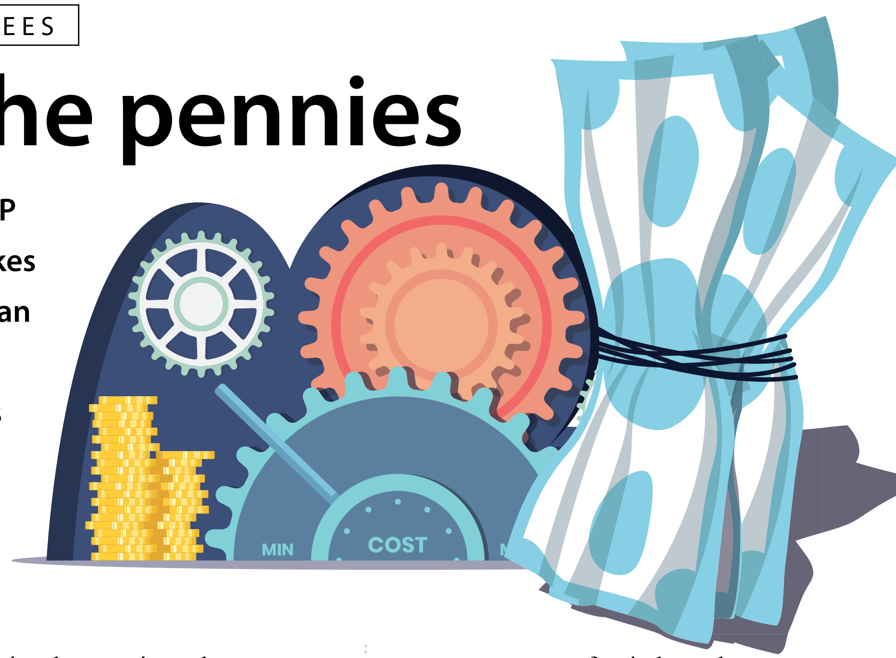
The flexibility on whether to pay for insurance coverage has been there for many years, but now the default option for new low-contribution members will be to not include insurance. Commenting on the difference it could make to a member’s pension pot, Harmer Lassen says that it depends on individual circumstances but for those that are young and will remain a low-contribution member for the long term, the policy change will make a “significant difference”.



FEES

Counting the pennies

Amid EIOPA's consultation on IORP costs and charges, Sophie Smith **takes a closer look at why pension fees can be so complex, and what can be done to protect members' savings from being chipped away by both fees and taxation**



WRITTEN BY SOPHIE SMITH

Money makes the world go round, but amid the pandemic many have begun penny-pinching, and the pensions industry is no exception. With every penny in costs taking more away from members' savings, many organisations have been asking just what their pension pot charges are covering, and how they can be kept from getting out of hand.

Indeed, the European Insurance and Occupational Pensions Authority (EIOPA) recently launched a consultation on proposals for the supervisory reporting of costs and charges of Institutions for Occupational Retirement Provisions (IORPs). The draft proposals have provided a generic classification of all costs to be reported to national supervisors, including templates, as well as outlining principles for the compilation of cost information, including the look-through principle, which means that direct investment costs will have to be reported alongside indirect costs at the level of investment managers.

This is a key issue around pension fees, as Willis Towers Watson senior director developing and emerging markets leader, Michael Brough, explains that pension schemes must be mindful of the questions they are asking. "If you ask a provider how much it costs they might tell you how much the annual management charge is, but you have to ask the right question, you have to ask how much the total expense ratio is," he says, explaining that this will then take into account other expenses, such as audit costs, stamp duty and taxes.

"If providers are only disclosing the bare minimum charge under disclosure legislation, this may result in certain other charges being hidden," agrees LCP Ireland partner, John Lynch, warning that if these turn out to be material, it may have a very negative impact on trust, which may result in a lower pension take up.

Getting the bill

Lynch also emphasises that there is no clear definition of a "charge" under current disclosure legislation in Ireland, suggesting that this could be tightened up to ensure consistency among providers and that all relevant deductions are captured.

Indeed, the Irish Labour Party has recently called for legislation that would force pension providers to be more transparent, after independent analysis conducted on pension fees reported losses of hundreds of thousands of euros per person due to fees. Commenting at the time, Labour TD Ged Nash, the party's spokesperson on finance, public expenditure and reform said: "This independent research was provided to me and it raises major questions about the scale of pensions fees in Ireland, and it also raises major questions about the complete lack of transparency about those fees."

"We would agree that greater transparency would be beneficial to members," Lynch says, suggesting that legislation is the only practical way to ensure full disclosure, with any light touch requirements potentially resulting in different pension providers adopting different positions and making comparison more difficult.

And, work is underway to improve transparency more broadly, as OECD principal economist, Pablo Antolin, highlights initiatives to improve transparency as being the principal policy tool that jurisdictions have implemented for strengthening competitive pressures in private funded pension systems;

supplemented by regulations to control pricing and/or structural measures to influence the set-up of the pension market or the products offered by pension providers.

He clarifies, however, that no single policy response is effective in isolation to address weak market mechanisms, emphasising that measures to improve transparency are necessary but are not sufficient to align costs and charges. “Rather,” he explains, “other solutions such as benchmarking, pricing initiatives, and structural solutions are also warranted. These policy options offer ways to better align costs and charges as well as ways to improve overall outcomes.”

Indeed, the Swedish Pensions Agency has recently published a recommended benchmark that sets 0.2 per cent as a low annual fee for global equity index funds, down from the previous benchmark of 0.4 per cent. The move is part of its efforts to increase saver awareness that the fee on selected funds has a negative impact on pension pot develoment.

Capping costs

A charge cap is another suggestion often highlighted to prevent pension costs from creeping up too high. The *OECD Pensions at a Glance 2019 Report,* revealed that 12 out of 20 reporting countries cap some of the fees that pension providers can charge to members, whilst further research from IOPS, which includes non-OECD countries, found that out of 28 jurisdictions, 62 per cent, have legal caps on fees.

Issues around scale can also impact efforts made to control costs through charge caps, however, Antolin warns, that, in order to capture economies of scale on behalf of members, charge caps should not be static. “For example,” he says, “Costa Rica initially capped fees at 1.1 per cent and this has reduced to 0.35 per cent in 2020. In Estonia, fees must be reduced by 10 per cent for each €100 million increase in assets.”

Brough echoes this, warning that an undeveloped defined contribution (DC) market that is lacking assets can cause challenges, as has recently been seen in Poland. “One provider said to me that if they were starting from scratch without any money in the pot it would take them about 11 years to make a profit,” he says. “So, it’s a long game for pension providers and insurers to make money from these things, particularly where the fees are capped.”

Mercer strategic European risk management leader, John O’Brien, also warns that whilst fees can erode returns over longer periods of time, a blanket approach to minimising fees could risk lowering the alignment between the rewards of portfolio managers and those of their clients, potentially denying access to skilled managers who are more likely to add value in less efficient or illiquid markets. “Fee caps should also not come at the expense of lower levels of customer service, provider governance or risk management,” he emphasises.

Furthermore, Antolin warns that if the cap does not include all direct and indirect costs, then providers might have an incentive to exaggerate uncapped costs in order to compensate for any lost profits in areas that do fall within the scope of the cap.

Adding to this, Antolin acknowledges that establishing the correct level of the cap is especially complicated in markets where providers have different cost structures. “Setting the cap in line with the cost structure of large, vertically integrated providers might squeeze out smaller providers,” he warns, emphasising however, that a relatively high cap could enable lower-cost providers to generate excessive profits, unless there was pressure from participants or other stakeholders to reduce charges.

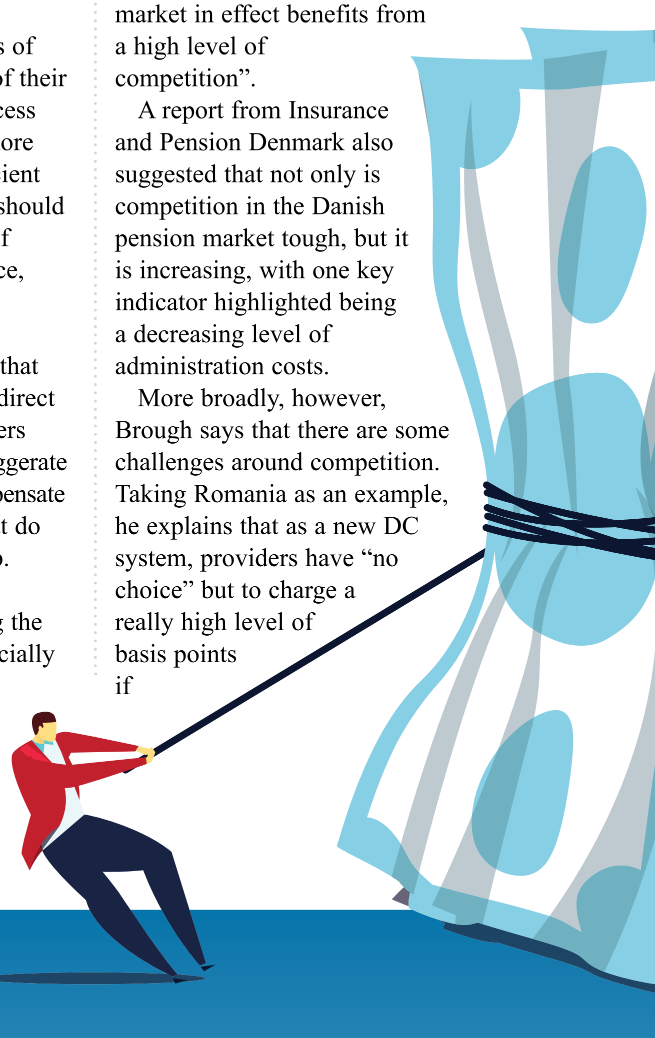
Creating competition

And whilst competition can play a broader role in regulating costs, in practice, this may not always be the case, with the Danish Competition Watchdog recently criticising the country’s pension companies for the high fees they charge to manage funds, which it said total DKK 14.4bn a year.

This is not a universally recognised picture though, as Insurance and Pension Denmark deputy director, Torben Weiss Garne says: “Through an extremely high degree of openness and transparency... the Danish pension market in effect benefits from a high level of competition”.

A report from Insurance and Pension Denmark also suggested that not only is competition in the Danish pension market tough, but it is increasing, with one key indicator highlighted being a decreasing level of administration costs.

More broadly, however, Brough says that there are some challenges around competition. Taking Romania as an example, he explains that as a new DC system, providers have “no choice” but to charge a really high level of basis points if



companies and individuals aren't happy to pay fixed charges. "In markets like that, all of the providers who are operating have excessively high fees because there's no other way of making any sort of long-term business."

Agreeing, O'Brien says that an ideal system should encourage competition and flexibility to suit members' needs while encouraging economies of scale.

"In Ireland, according to EIOPA there are over 3,600 IORPs with an excess over 12 members – while this may support flexibility choice, it is hardly consistent with economies of scale, except for the very largest schemes," he continues. "An element of consolidation, most obviously through master trust solutions, could help deliver fee savings across a wider number of schemes."

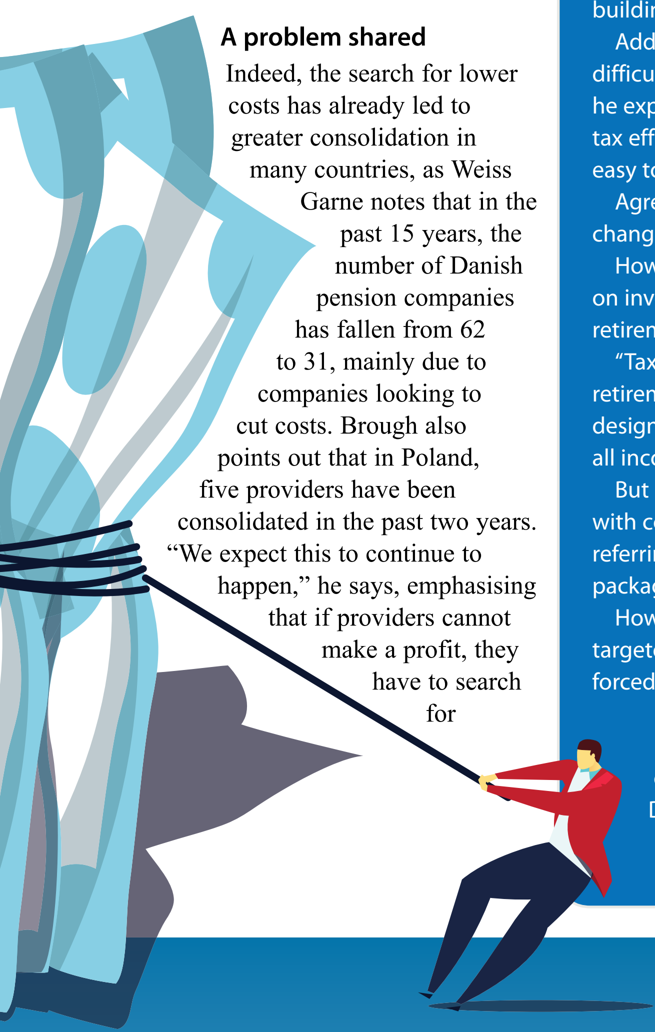
A problem shared

Indeed, the search for lower costs has already led to greater consolidation in many countries, as Weiss Garne notes that in the past 15 years, the number of Danish pension companies has fallen from 62 to 31, mainly due to companies looking to cut costs. Brough also points out that in Poland, five providers have been consolidated in the past two years. "We expect this to continue to happen," he says, emphasising that if providers cannot make a profit, they have to search for scale elsewhere.

And whilst Brough supports the idea of having global standards to protect the interests of members, he warns that this might not work for less developed DC markets, warning that consideration must also be given to the sustainability of the market.

"Any directional support is good, but DC pensions take a long time to make profit because the upfront costs are so high," he stresses. "These costs need to be reflected in templates so that the system is viable."

With a raft of countries, such as Gibraltar, Thailand, Ukraine and Russia, set to introduce further DC auto-enrolment-style systems in the coming years, consideration of costs will continue, as Brough predicts the use of charge caps in these countries too, concluding: "There should be fairness both in terms of what members are expected to pay, but also for the providers, otherwise they can't provide a sustainable product."



Pension's tax - incentive or obstacle?

Pension fees are not the only unexpected costs that can erode members' savings over time, with the complicated tax structures surrounding pensions often causing confusion and unexpected surprises for savers.

"Tax is used as an incentive in many countries," says O'Brien, arguing however, that it can be a difficult balance to achieve, with stability of treatment critical in building trust.

Adding to this, Lynch stresses that members find pensions complicated and difficult to understand. "Part of this complexity is due to how tax relief operates," he explains. "Any reform of the pension tax regime should ensure that it remains tax efficient to save for retirement for all members. It should also be simple and easy to apply," he emphasises.

Agreeing, Antolin warns that complex tax incentives' structures and frequent changes to tax rules may reduce the impact of tax incentives on pension savings.

However, according to *Mercer's CFA Global Pension Index 2020* report, tax relief on investment earnings is critical in respect of adequacy as most of an individual's retirement benefits are due to investment earnings and not contributions.

"Tax rules should therefore be straightforward, stable and common to all retirement savings plans in the country," Antolin stresses, suggesting that the design of tax and non-tax incentives for retirement savings should at least make all income groups neutral between consuming and saving.

But amid the impact of the pandemic, further easements on tax seem unlikely, with countries such as Denmark introducing new taxes on the financial sector, referring to the societal obligation to pay back to society after bank relief packages introduced during the financial crisis in 2008.

However, Weiss Garne warns that the insurance and pension sector will be targeted by the bank tax as well. "Why the insurance and pension sector is being forced to pay this new tax is a mystery to us", he says, suggesting that the proposal should ideally be withdrawn. "The arguments used by the government have nothing to do with the insurance and pension sector. In effect, this new tax burden will unfortunately harm the customers of the Danish insurance and pension sector."

DB FUNDING LEVELS

Bouncing back

European DB schemes' funding levels unsurprisingly fell when the impact of Covid-19 prevention measures first hit investment markets. But funding levels have already bounced back to impressive highs. Laura Blows **explores what this means for schemes' investment strategies**

WRITTEN BY LAURA BLOWS

This time last year saw European defined benefit (DB) pension schemes in a bleak place.

"When the pandemic spread across Europe in the first quarter of 2020, this created incredibly difficult conditions for many pension schemes," Newton Investment Management head of UK institutional, Jenny Yoo, states.

This is evidenced, she says, by looking at the UK PPF 7800 index, which showed a worsening in funding ratios from 98 per cent at the end of 2019 down to 93 per cent by the end of the first quarter of 2020.

The drop in equity markets gilt yields can be attributed for this fall. For instance, Yoo highlights that in the month of March 2020 the FTSE All-Share Total Return Index dropped by 15.1 per cent, with US equities experiencing an even steeper decline (the S&P fell over 30 per cent in the month). Meanwhile, 10- and 20-year fixed-interest gilt yields decreased by 7 per cent.

"These were some of the largest and fastest market declines ever seen," Yoo says. "We have heard of schemes that started 2020 in surplus but just three months later had a deficit three times the size of that surplus."

The story was the same in Ireland, with the significant falls in global equity markets, during February and the first half of March 2020, resulting in a short period where the funding levels of Irish DB schemes that were heavily exposed to equities were adversely impacted.

"In particular, this would have impacted defined benefit plans with 31 March year-ends under the Irish minimum funding standard," Aon's Irish Retirement Solutions Business CEO, Rachael Ingle, explains. "That said, there was no obvious impact on the strength of employer covenants during this period – DB schemes, generally speaking, continued as normal."

A silver lining during these falling equity rates, wider credit spreads and gating of less liquid funds was higher spreads in pension liability discount rates – "a welcome intervention that helped stabilise corporate balance sheets at a potentially difficult time", Mercer head of strategic risk management for Europe, John O'Brien, says.

Improvements

The recovery in equity markets throughout the remainder of 2020 and into 2021 contributed positively to the funding position of those Irish DB plans with a significant allocation to equities, Ingle notes.

Volatility on financial markets in the first quarter of 2021 had a significant impact on pension funds across all jurisdictions, Amundi head of outsourced investment management (OCIO) advisory, Karin Franceries, agrees.

There was the return of the inflation narrative and the massive rise in yields, she says, with the US's fiscal stimulus seeing Treasury yields rise by approx 80 bps, affecting yield curves across the board. For instance, UK 10-year and 30-year gilts increased by 65 bps and the German bund by 25 bps.

"These rising yields significantly decreased the DB obligation of marked to market liabilities, but as hedge ratios were usually below 100 per cent, hedging assets tended to decrease less than liabilities, while growth assets were supported by good resistance of the credit market and strong performances across asset classes," Franceries says.

"As a consequence, funding ratios generally improved over the period."

And improve they have, to impressive levels considering the global pandemic playing out around them.

"The latest phase of the Covid crisis has had a surprising effect; the funding status of pension funds across the world improved drastically and, according to some measures, is at a three- to five-year high," Franceries says.

Between Q4 2019 and Q4 2020, European pension funds' assets increased by 9.2 per cent and liabilities increased slightly less, by 8.9 per cent, PensionsEurope CEO, Matti Leppälä, highlights.

"Currently, on aggregate national level, European DB schemes are well or fully funded. For instance, European pension funds' assets, at €3,156 billion, clearly exceed their liabilities of €2,785 billion," he says.

Giving the example of the UK, Yoo states that the UK PPF 7800 funding ratio had increased to 102 per cent by the end of March 2021. At the same time, the FTSE All-Share Total Return Index gained almost 27 per cent, with gilt yields rising by over 50 bps.

"WE HAVE HEARD OF SCHEMES THAT STARTED 2020 IN SURPLUS BUT JUST THREE MONTHS LATER HAD A DEFICIT THREE TIMES THE SIZE OF THAT SURPLUS"

Looking to the Netherlands, Franklin Templeton institutional sales director, Remco Van Dijk, highlights that Covid-19 isn't the main driver impacting funding levels; it is the interest rate.

"Dutch pension funds need to discount their liabilities against a certain interest rate, so a higher interest rate means a lower present value of liabilities and vice versa," he explains. "In April, with a small rise in interest rates due to inflation expectations, the average funding level rose to above 100 per cent. A commonly used sentence amongst pension fund board members is that you only have to look at your funding level, to know what the interest rate movement has been."

Considering that 85 per cent of the 600 largest European companies offer DB pension funds, this increase in funded status is excellent news, Franceries says, as it can lead to a reduction in pressure on their financial leverage.

An increase in funding will translate into a one for one increase in shareholders' equity and a reduction of the same amount in their net debt, she explains. It also has a positive effect on cashflows, with contributions likely to be lower if pension funds are at or approaching full funding, and on their profit and loss as pension costs are proportional to liabilities.

Opportunities and concerns

"It hasn't all been bad news for Irish DB plans," Ingle agrees. "2021 has finally brought some respite for trustees and sponsors with increases in government bond yields improving funding levels. This is likely to provide opportunities for those DB plans that hold a high proportion of return-seeking assets, low matching asset allocations and liability hedges and those that provide retirement benefits with fixed increases."

Some schemes took opportunity in dislocated markets, O'Brien adds, "especially in the credit and private markets space".

According to O'Brien, a welcome development in 2021, especially for European investors that have been dealing with negative interest rates for quite some time, has been the sell-off in longer-dated bonds that has helped to lower liability valuations and ease pressure on funding levels.

In the Benelux institutional market, pension funds are increasingly seeking alternatives to European government bonds, Van Dijk also finds.

"They do this firstly because of the low-yield environment, yet also to protect against inflation. This resulted in larger allocations to alternative fixed income (mainly mortgages) and real assets, the latter being considered as a hedge against inflation," he says.

"Real assets however also present a challenge. With large flows to real estate and infrastructure funds, many of these funds face difficulties in putting the money to work. That means that institutional investors experience quite some delay in having their committed capital called. A waiting period of over one year is not an exception."

Yoo has also experienced UK pension schemes being concerned about rising inflation. Whilst real estate has been a traditional inflation hedge, she is also seeing more schemes expressing interest in staying in liquid assets, "as their investment timelines may now be shorter due to the improved funding positions".

There has also been growing interest in both multi-asset funds and absolute return bonds, which incorporate liquid inflation hedges such as commodities and floating rate notes, whilst focusing on capital preservation, she adds.

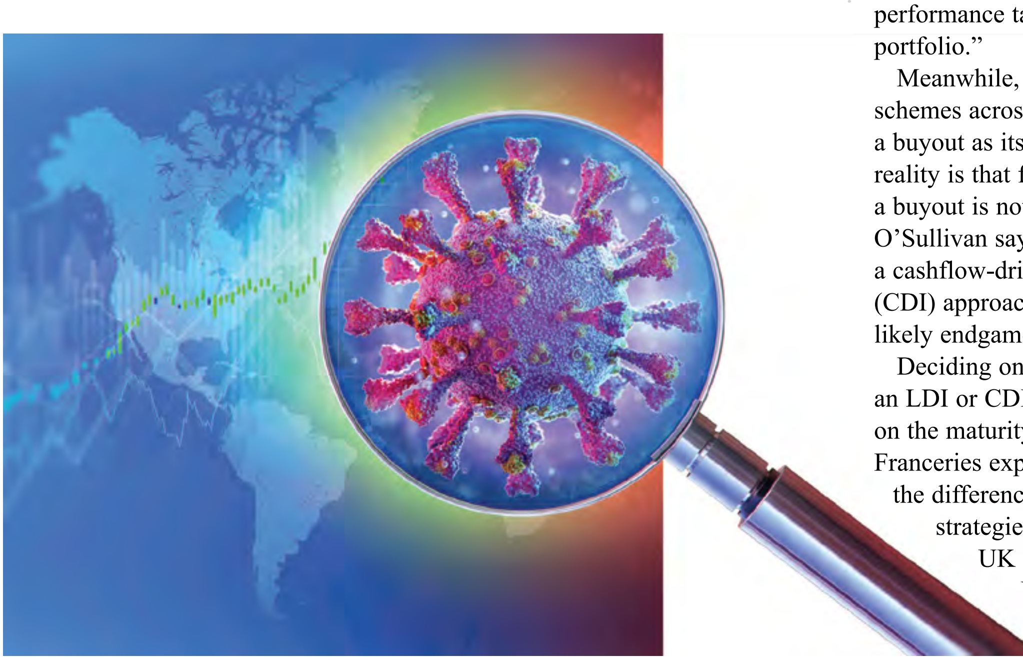
This need to protect against inflation is proving to be a major concern for all pension schemes.

"Even where pension benefits are not formally linked to inflations, we see many pension managers worry about the extent to which the fiscal and monetary stimulus packages needed to kickstart economies may erode the purchasing power of pension benefits," O'Brien warns.

While pension funds have generally positive expectations for the economic recovery in 2021, the continuing low/negative interest rate environment will continue posing challenges to pension funds, Leppälä also warns.

Investment strategies

According to Schroders solutions manager, Patrick O'Sullivan, for many pension schemes, the position they find themselves in now will largely be dictated by the policy to hedging interest rate risk they had in place prior to Covid-19.



"Rates have remained low and so schemes that had not put in place an LDI programme may have found that, while the asset side performed well, their liabilities have similarly increased," he says.

"They will have been particularly affected by Covid, with declining interest rates depressing funding levels as liabilities increased. This will have compounded losses observed on cyclical assets as credit spreads widened and equities fell in response to the uncertainty surrounding Covid-19, especially during those early lockdown days.

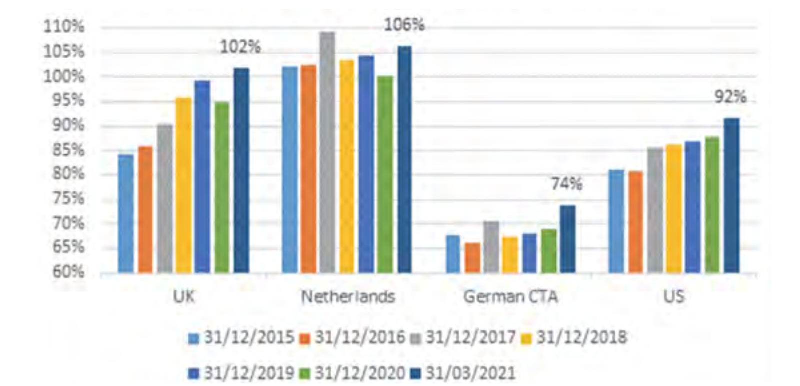
"For those who did not hedge it may be natural to think 'surely rates can't fall further'. However, we are yet to see the rise in rates hoped for by unhedged pension funds. Those schemes will now need to ask themselves how much risk they are willing to take.

"This points to the need for schemes to consider implementing a liability driven investment (LDI) programme to protect themselves against the funding level risks associated with interest rates and to ensure they have a clear performance target for their portfolio."

Meanwhile, while mature pension schemes across Europe may have a buyout as its ultimate target, the reality is that for most schemes a buyout is not a near-term option, O'Sullivan says. As a result, a cashflow-driven investment (CDI) approach may be the most likely endgame solution, he adds.

Deciding on whether to implement an LDI or CDI strategy depends on the maturity of the scheme, Franceries explains. She highlights the difference in investment strategies between Dutch and UK schemes, due to the UK DB landscape being in run-off, while the Dutch

Pension funding status evolution since 2015



Source : PPF for UK s79 funded status, DNB for Dutch funded status, Aon Tracker for US funded status and Amundi estimates for German CTAs, as of May 2021.

"FOR THOSE WHO DID NOT HEDGE IT MAY BE NATURAL TO THINK 'SURELY RATES CAN'T FALL FURTHER'. HOWEVER, WE ARE YET TO SEE THE RISE IN RATES HOPED FOR BY UNHEDGED PENSION FUNDS"

market is still open for business.

"In the Netherlands, DB pension funds need to continue running the funds, meaning investing in risky assets on one side and liabilities hedging on the other. As they wait for the pension reform to come into effect, DB schemes are focused on interest-rate hedging, via LDI, and are less focused on CDI strategies, as LDI strategies are meant to primarily hedge liability risk such as duration or inflation and not to increase returns thanks to cashflow-oriented growth strategies such as credit, loans or infrastructure.

"In the UK, pension funds look to de-risk their investments as they get ready for a buyout. They are moving out of LDI hedging towards a strategy combining cashflow-hedging through the use of credit instruments and return, despite risky assets' reduction. By doing so, they keep longevity risk, but reduce drastically investment risk. At the same time, they keep some upside thanks to the credit return of their portfolio."

With mature schemes undoubtedly continuing on a path of de-risking, secure-income assets can play a part and complement the hedging strategies many schemes already have in place, Franklin Templeton head of UK institutional, Dean Heaney, says.

"The tightening of credit spreads that we've witnessed since Covid started will have put pressure on the ability of pension schemes to implement a CDI solution without making use of illiquid credit," O'Sullivan adds.

However, Yoo points out that while the past few years has seen an explosion in private market investment, they may not be appropriate for mature DB schemes that are now closer to their end game.

She gives the example of a scheme with a significantly positive funding ratio but with almost 30 per cent of its portfolio in illiquid assets, some mandates with almost 10 years to maturity, "making it difficult to move to full buyout at this optimal time".

Therefore, she recommends considering liquid, flexible absolute return bond strategies as a higher return alternative to cash.

Future plans

However, as a number of schemes have been "taken by surprise by their now well-funded position", Yoo expects a rise in the numbers of buyouts in the coming months.

"We believe the consolidation we are seeing across the UK pension fund landscape will continue more rapidly as sponsors look to remove the pension fund from their balance sheets – this should benefit both OCIO firms but also some of the newer entrants to the consolidation landscape," she says.

European DB schemes' improved funding positions may have generated opportunities to de-risk or implement new investment strategies, but are these positive funding levels expected to last?

To answer this question, Franceries looks to Amundi's expected returns on asset classes that are typically relevant for pension funds in the Eurozone and the UK.

It finds that the current policies should go beyond pandemic contingency until the full recovery of major economies and that there will be lower medium-term returns. In the long term, there is expected to be a convergence to a weak growth potential, while inflation remains under control around central bank targets, implying some downside adjustments to equilibrium yields and the earnings growth trend.

Therefore, according to Franceries, "with our assumptions and a similar allocation as of today, the funded status of the average pension fund will remain stable over the next five years in Europe and in the US, and will continue to improve in the UK from 102 per cent to above 120 per cent". ■

INFLATION EXPECTATIONS

Ask the industry:

With inflation expectations rising around the world amid the prospect of a Covid-19 recovery, how can pension schemes protect their investments?

"Inflation will be a hot topic this year, but currently we do not see a strong case for the inflation dynamic to drastically change compared to the trend seen before 2020. Solid inflation in 2021 coupled with expansive monetary policies investors have been adding to their inflation hedges across mature economies.

Historically, higher inflation has been associated with higher interest rates, which isn't necessarily a bad thing for pension schemes across Europe. Where we would recommend being vigilant is that in some countries, such as the Netherlands, some pension funds regulations tend to be procyclical. Pension funds may be tempted to add inflation hedges following a move higher in interest rates because they find themselves with a higher funding ratio. When yields are higher, inflation expectations are actually often also higher, making the cost of hedging inflation less attractive.

In our experience the inflation market tends to be procyclical, higher inflation leads to higher inflation expectations. We see this as an opportunity; we believe that pension funds could use inflation-linked bonds more when inflation expectations are depressed as long-maturities-inflation-linked bonds provide both duration and inflation hedging benefits. Following such a strategy would help them to avoid overpaying their inflation hedges."

JONATHAN BALTORA **AXA IM head of sovereign, inflation and FX - core fixed income**

"Schemes with inflation-linked liabilities will face the risk of deteriorating funding positions, as the value of those liabilities rises as inflation expectations increase. However, equally important is the trajectory of long-term interest rates, as rising interest rates can help to mitigate the impact of increasing inflation expectations. LDI hedging strategies can help to provide protection against adverse movements in both, whilst real – or illiquid – assets are likely to be increasingly attractive, particularly those with inflation-linked revenue streams such as real estate long income."

TOBY BALDWIN
Aviva Investors head of DB solutions

"The investment implications of a higher inflation environment are extremely dependent on the monetary policy reaction. Aggressive policy tightening would have a very different impact than if central banks allowed higher inflation. We believe the latter is more likely, and therefore that inflation will accelerate. Nominal government bonds are therefore likely to perform poorly. Inflation-linked government bonds are a better fixed-income alternative, as the coupon and principal repayment are linked to a national (or Eurozone) inflation index. 'Linkers' will perform particularly well if central banks keep policy rates unchanged at low levels, which will help to limit the rise in real yields.

If central banks hike rates, inflation-linked bonds will still perform better than nominal bonds, but the total return might well be negative. In this environment, the best fixed-income alternative is cash. Outside the fixed-income world, equities are likely to perform rather well, especially if the higher inflation environment is accompanied by stronger economic growth and relatively dovish central banks. However, some equity sectors, like US tech or growth shares, have a longer duration and might underperform in a rising yield environment."

JACO ROUW
NN Investment Partners senior portfolio manager LDI & rates

"The recovery from Covid-19 and the large fiscal stimulus in the US will probably raise global inflation for the next two to three years, stemming from demand, cost and supply chain pressures. However, we see this as unlikely to present a long-term inflation risk. There is policy bias for greater inflation tolerance given higher post Covid-19 indebtedness, but central banks are unlikely to allow a sustained period of higher inflation. Inflation risks on a long-term basis (10-year type horizons) remain well contained in our view.

For those European schemes concerned, policy options are to hedge directly using inflation markets or indirectly through inflation-sensitive asset classes. France's inflation-linked market is the first port of call (or its CPI swap equivalent). Twenty-year French breakeven inflation has risen steeply in the past few months and now about 15-20 bps higher than pre-pandemic levels.

At still under 1.5 per cent (a bit higher for swaps), however, this is not that expensive versus consensus views on expected inflation which appear to be in the 1.5 per cent-1.75 per cent range for long-term euro inflation (even though we are past the best point when hedging costs were much lower). Other inflation markets can also be considered (with appropriate exchange rate hedging), but we consider the two logical alternatives, the UK and US to be expensive and fully priced, respectively."

TAPAN DATTA
Aon partner and head of global asset allocation

"The latest phase of the Covid-19 crisis has had a surprising effect: higher rates and strong risky assets' returns translated into record funding status. This should theoretically be followed by an increase in hedging for pension funds, especially those in surplus as is often the case in the UK and Netherlands.

On the other hand, stimulus packages and quantitative easing have renewed inflation concerns. Should it necessarily be a worry? We believe the differentiating factor will be growth; inflation and growth together are positive for risky assets (our three-year expected return for European equities is 6 per cent), whilst they reduce hedging assets and liabilities. Both effects translate into improved pension funding – this is our central scenario.

A stagflation scenario, with low growth and above average inflation, is less likely. It would hurt pension funds (in that scenario, our three-year expected return for European equities would be below -7 per cent) especially those with inflation-linked liabilities (e.g. in the UK). For others, like in the Netherlands and in Germany where inflation indexation is not automatic, the pain will be less acute.

Our recommendation is therefore as follows: pension funds should consider increasing their hedge ratio to protect their improved funding, with a focus on inflation strategies in the UK. But it is not yet time to give up on risky assets to fill a shortfall as our main scenario remains positive for risky assets."

KARIN FRANCERIES
Amundi head of OCIO advisory

"As the vaccine-led recovery proceeds inflation will accelerate temporarily. There are already some signs of it. However, it is likely to be short-lived, and unlikely to get out of control.

Rapid economic recovery, already going on in the US and China, is raising prices especially quickly in cyclically sensitive commodities – like raw materials, food, and fuels. Transitory price increases take place, not just because the economy is booming, but also because pandemic have produced disruptions in global supply chains. These are expected to disappear once the economies normalise.

Inflation concerns are greater in the US than in Europe because comparative relief measures there have been on a completely different scale. The US economy is also recovering because of the rapid pace in its vaccination. Europe is proceeding in a slower pace. The Federal Reserve has indicated that it is prepared to tolerate inflation climbing up to 2.5 per cent and would not hike interest rates anytime soon."

RISTO VAITTINEN
Finnish Pension Alliance Tela chief economist

In their own words...

Industry personalities' comments on the hot topics affecting the European pensions space

On the increasing popularity of retirement saving in Finland

"The share of persons saving for retirement has increased by seven percentage points compared to previous studies. At the same time, the share of persons not saving has been reduced by five percentage points. The link between trust in the pension system and saving is not straightforward, though. On the one hand, those who distrust the pension system more often save. On the other hand, saving was also more prevalent among those who were positive about pensions securing a reasonable economic welfare in retirement and who thought that pension assets are managed reliably."

Finnish Centre for Pensions economist, Sanna Tenhunen

On the Danish pension industry's DKK 660 billion worth of investments in unlisted assets

"Pension companies invest more broadly than just the classic government bonds and listed companies. Today, they also invest in, for example, wind farms and companies outside the stock markets. This is of great benefit to pension savers, both because we spread the risk and because we ensure a better return for savers than, for example, government bonds can provide."

Insurance and Pension Denmark deputy director, Tom Vile Jensen

On a report showing that pension fees cost some Irish savers thousands of euros

GED NASH

Irish Labour Party Teachta Dála

"This report shows how ordinary people are paying extraordinary sums of money from the pension pot they've worked hard to fill over time. When a young person starting out in their career signs up to a pension provider, fees of 2 per cent or 3 per cent sound small at the time, but what many don't realise is that these fees are applied every year to the entire pension pot, which builds over time, and ends up being an eye watering sum of money."

On taking a total portfolio approach to environmental, social and governance (ESG) investing in China

LIANG YIN

Willis Towers Watson director, investments research team, and China project lead

"Sustainable investing is not just about properly integrating ESG-related information for risk management purposes. It is also about recognising that long-term ESG-related themes, such as climate change, can create return opportunities. China has in recent years emerged as a world leader in funding and developing technologies to combat climate change and its net-zero pledge will greatly influence economic and climate policies in the decades to come. Moving forward, we expect China to be a major source of climate change-driven investment opportunities."

On research showing that the average Swedish pensioner receives 75 per cent of their pre-retirement income

STAFFAN STRÖM

Alecta pension economist

"Pensioners' income is clearly better than what has previously been the case, and contrary to what many believe, their income has also increased over time. Some of the reasons for this are that more people now have the health to work until retirement, that more and more people choose to continue working after 65 and that occupational pensions have delivered strongly. The Swedish pension system is far from perfect, but the gloomy picture many have of a system that is collapsing is simply not true."

On what has led UK defined benefit scheme deficits to fall by £4 billion

ESS PAGE

Mercer partner and trustee leader

"April saw further gains in growth asset prices, with the spring optimism observed last month continuing despite the nip in the air. Economic data continues to look robust, with a recovery in services on the back of vaccination efforts and the gradual lifting of social distancing measures. With pension scheme funding levels stable, many trustee boards and sponsors are focusing on long-term strategy and risk management, particularly with the recent announcements from The Pensions Regulator on the proposed new code of practice and requirements for schemes to conduct an 'Own Risk Assessment'."

On Sweden's changing average retirement age

"One explanation for why more people in the younger generations take out a pension at an older age, may be that they want a higher income-based pension. Another... is that it is fiscally favourable to continue working after the age of 65, which can lead to more people waiting to receive the general pension."

Swedish Pensions Agency analyst, Erik Granseth

On using digital solutions to increase member engagement

"Member engagement has always been a challenge for schemes. In the last year, many members have moved into a more physically isolated environment, meaning the quality of member communications is more important than ever. And effective technology has been the lynchpin in enabling employers to continue to deliver on the social contract. Digital solutions that involve members and 'nudge' them towards interacting with their pension are a huge step forward in engaging individuals, both at the day-to-day level and in conjunction with any specific exercises schemes may aim to undertake."

Buck UK head of outsourcing, Lee Cook