OUTLOOK

A balanced approach

Sandra Haurant looks at the investment trends pension funds should be considering in 2020 with diversification and ESG issues remaining on the agenda

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The financial crisis may have reached its lowest point over a decade ago, but the memory for many is still fresh. And with the surprise twists and turns of geopolitical plots that we have seen over the past few years, the pensions investment industry could be forgiven for choosing to expect the unexpected, rather than making clear predictions of what the 2020s may have in store.

It may not be possible to forecast what the coming year, let alone the coming decade, could hold, but even in turbulent times such as these, certain trends have been taking shape. So what are the key preoccupations for this ever-changing pensions industry?

Horses for courses

If there is one thing the pensions industry needs to do, says PiRho Investment Consulting director, Nicola Ralston, it's to recognise that everyone is different, with distinctive goals and requirements.

"We need to stop referring to pension funds as if they all face the same issues," she says. "After all, funds are not a homogenous group – differences in beneficiary demographics, in size, in geography, and many more areas, mean that priorities for funds across the UK and Europe will never be quite the same."

Payden and Rygel principal, Mark Stanley, agrees. For example, he says: "The priorities differ between defined benefit (DB) and defined contribution (DC) plans, even though ultimately they face similar challenges – rooted in persistent low interest rates and the need to generate yield.

"For DB, where schemes are maturing rapidly, there will be increased focus on cashflow. Many are now cash negative, in other words, the outflows to pay pensions and other benefits such as transfer values, exceed the inflows from contributions. For DC, there's encouragement to incorporate less liquid, long-term assets into the mix, but I also believe that more work will be done on the drawdown phase for those closer to retirement."

PwC Luxembourg market research centre partner, Dariush Yazdani, agrees. There is an important balance to strike, he says: "Choices around liquidity will come down to the age and requirements of beneficiaries. In an ageing population, a pension fund will need to shift from higher risk, long-term investments into short term, more liquid, investments in order to be able to pay out their beneficiaries."

It's an area that many pension funds will be looking at very closely, says Mercer investment consultant, Matt Scott: "The priority for DB schemes continues to be to reduce their funding deficits and to focus on what an 'end-game' investment strategy looks like. With the outlook for investment returns being low, pension funds will need to be more creative about finding sources of returns."

Spreading the net

And getting creative may mean keeping an open mind and investing widely, says Scott. "This isn't the time to give up on diversification. Although investors with limited levels of diversification have been well-rewarded in recent years, we do not expect a repeat of the past decade's equity and bond returns." Those with less constrained allocations and a broad spread of asset classes within their portfolios will perhaps be best-placed to capitalise on dislocated markets.

Stanley adds: "In terms of asset classes, the need for yield will continue to drive interest in alternatives to traditional government bonds – in some European countries, concerns extend

beyond just low yields but also to downgrade risk. In our view, the global securitised market, which is diverse and liquid, offers significant opportunity for investors, capitalising on the complexity premium."

Emerging market debt is also attractive, he says, suggesting this area may benefit from a weakening US dollar. "Equities, too, can be re-cast as an asset class which generates yield: we are likely to see a period of lower capital growth from equities, so a reliable mid-single digit return from dividends will look attractive."

However, Cardano chief investment officer, Keith Guthrie, warns: "The biggest challenge for many pension funds is determining an appropriate asset allocation that does not leave them vulnerable to shocks in the economy or exposed to unattractive return profiles."

Many, he says, were surprised by interest rates moving lower once more in 2019, and, he cautions: "If we have a further economic slowdown, that could happen again. Funds that are not appropriately hedged on liabilities could face further pain." What's more, he says, inflationary risks, too, could pose a threat to those with investment strategies that are not ready to cope with this type of risk.

One clear focus

Diversification of assets may be crucial, then. But there is another clear area of focus that will preoccupy pension fund investors, along with the rest of the world. "Whilst climate change can feel like a long-term issue, with long-term consequences, for long-term investors, we believe that the risks for investors are clear and present," says Scott.

Mercer's global head of investment research, Deb Clarke, adds: "Environmental issues are broader than climate change. The top five global risks in the World Economic Forum's *Global Risks Report 2020*, in terms of likelihood, are all environmental, and include biodiversity loss as the second most impactful and third most likely risk for the next decade." But, she says, while this represents a challenge from an investment perspective, most European pension funds already identify climate change as a financially material risk, and as such are looking for ways in which they can manage their exposure.

"This might be done through more sustainable strategic asset allocation decisions, via utilising investment managers who have a positive track record in truly integrating ESG into their investment processes, or ensuring their asset managers engage with companies to effect change," she says.

Association of the Luxembourg Fund Industry (ALFI) senior legal adviser, environmental, social and governance, David Zackenfels, says that environmental issues are also at the top of the regulatory agenda for Europe. "Sustainability and climate issues will be important for all, but pension funds are a different animal, in the sense that they have a long-term view," he says.

Sustainability related disclosure is a central pillar for Europe, and the EU's commitment to a Green Taxonomy, or classification, of investments should make it more straightforward for investors to identify and differentiate between 'green' financial products. By creating a common language around environmentally responsible investments, it will be easier to comply with regulatory standards and make well-informed decisions. "The issue of greenwashing will be challenged; it should be flushed out of the system by the new EU Taxonomy," Zackenfels adds.

Seismic shifts

We have already begun to see pressure from the investment world for greater attention to be paid to environmental matters. In a move led by the campaign group ShareAction, a group of institutional investors, including Brunel Pension Partnership, called on Barclays to begin phasing out financing energy companies that do not adhere to the Paris climate goals, for example.

Brunel's CEO Laura Chappell said at the time: "Brunel believes climate change poses significant risks to global financial stability and could thereby create climate-related financial risks to our own business operations, portfolios and client partner funds, unless action is taken to mitigate these risks."

"We think 2020 will be the year when the industry really wakes up to the wider challenges facing the world, with climate and broader social imperatives," Stanley says. "The journey so far has been to work to build a compliant policy around a myriad of ESG factors, but the combination of increased regulation and the glaring enormity of the challenge, will bring change.

"Investors are beginning to realise the role that they can play as well as the importance of mitigating risks as the global economy decarbonises." For Stanley, then, this means schemes will have to shift away from policies which are designed to avoid harm, towards a more proactive stance that will take an active role in change." ■