REVIEW

Aftershocks

The past year has been a busy time for the European pension fund sector. But what does the industry think has been the biggest change/development of 2016 for European pension funds?

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Long is the 2016 list of major events, spanning from the decision of UK citizens to exit the EU to the election in the US of Donald J Trump, with its announced programme of financial deregulation, massive tax cuts and protectionism and the humanitarian challenge of an unprecedented wave of migrants fleeing a burning Middle East. All of these will impact European economies and their financial markets, though little will be observable in the short run. The low interest rate environment definitely proved to be 2016's short-term key concern for European pension funds. In the Netherlands, four out of five of the biggest pension funds now stand below the local 90 per cent minimum funding ratio, increasing the likeliness of pension cuts for next year. In Germany, BaFin publicly underlined that German pension funds might soon be forced to cut benefits for retirees. In France and Italy, the situation is no less worrying, even if the problem arises in different terms.

Emmanuelle Choukrou, head of business development, pension funds and sovereign entities, Societe Generale Securities Services

The review of 2016 can be summed up in three words: 'increased geopolitical risk'.

Political risk by definition is a short-term shock with longer-term potential impacts. This risk is therefore challenging to the market and investors, not because it brings about change but because that change is often preceded by a long period of uncertainty – Brexit is a perfect illustration of this, we can price in the short-term impact but the longer-term consequences are harder to predict and there is little, or indeed no, visibility or certainty to provide comfort to markets and investors.

Political risk is increasing yet the markets show little sign of pricing this in; that is all the more reason why European investors should be cautious.

Ken Harvie, head of consultant relations, Unigestion

Even with the recent Brexit vote and the market turmoil that followed, UK pension schemes are holding up better than their US counterparts, who have experienced higher interest rates and better domestic equity returns. Sixty-four per cent of UK pensions remain on track compared to just 23 per cent of their US counterparts – it can best be described as a 'Tale of Two Cities'. Companies with the foresight to put their pensions on a de-risking path and move toward fixed income when rates were higher can continue to manage and reduce their risk. Pension plans that are still waiting for interest rates to rise to reduce their risk may be waiting much longer. But these plans can still act decisively to borrow to move into cashflow-matched portfolios, hedge their substantial downside exposure or transfer some risk.

Amy Kessler, senior vice president and head of longevity risk transfer, Prudential Retirement

There has been a keen focus on keeping the cost of DC pensions low to improve member outcomes and this has seen a large shift to passive investment.

The past year has also seen European pension schemes take a closer look at how to improve risk-adjusted returns, and a growing number of schemes are starting to consider introducing smart beta techniques to their default investment solutions.

Maiyuresh Rajah, senior DC investment strategist, SSGA

This year we have seen that a growing focus for pension funds is introducing long termism into their investment portfolios. Taking a truly long-term view on their portfolios is critical as transparency, accountability and ESG are top of mind with both pension funds and their stakeholders. Every investment needs to be backed by a positive story in order to be included, and passive indices are often unable to accommodate these considerations. This development around stewardship is pointing towards the domain where typically active management prevails and fits the trend where institutional investors favour concentrated portfolios and high active share strategies over benchmark-driven investments.

Stef Bogaars, managing director, European client group, Investec Asset Management

The biggest development of 2016 for the European pension funds industry was consolidation, which was a sensible step forward for many pension schemes.
European pensions schemes are under pressure as they have never been before. Increased longevity, regulatory constraints and distorted financial markets fuelled by loose monetary policy are all having a profound effect on the European pension environment and are challenging all pension schemes, in any form, to deliver long term, sustainable and meaningful pensions to members.
As an example, deficits of the UK's defined benefit schemes are growing and reached £1 trillion earlier this year, demonstrating the extent of the challenge facing the UK's pension schemes.
Defined Benefit scheme trustees managing deficits could ask the sponsor company to increase their contributions to a scheme, however many companies are not financially able or willing to do this. Another option is for trustees to change their asset allocations to target a higher-yielding portfolio.
Another consequence of the loose monetary policy and low interest rates has been that equities valuations have soared. While this has been a boost to pension pots, valuations are at such historic highs it naturally lowers future return expectations. For DC schemes, members will certainly have to put more aside, work for longer or lower their expectations for retirement.

Anthony King, CEO EMEA, PineBridge Investments

We are in a world of historically low bond yields and negative real interest rates, which creates a massive headwind for long-term investors. Against this backdrop, this year we have seen the rejection of globalisation and the establishment play out both at home and away, with the UK voting to leave the EU and the US vote for a president without any political experience. These geopolitical shocks have created uncertainty that has further challenged underlying fundamentals and resulted in more volatility in the global equity markets. Pensions schemes are now having to navigate and protect against further bouts of volatility; in Europe there are key political events diarised, including elections, the outcomes of which could lead to further market shocks. However, times of change provide active managers with the chance to truly demonstrate their value by successfully identifying the investment opportunities and managing volatility, improving the outcomes of pension investors."

Andrew Brown, client relationship director, Columbia Threadneedle

In the Dutch pensions market (and in many other pension markets across Europe) the most important change over the past 12 months has been the structural and deepening underfunding position of DB schemes and transition to DC pensions.
To maintain their longstanding DB schemes the Dutch have tried it all over the past two decade: Increasing premium contributions up to 40 per cent of gross salary, derisking the investment strategy, relaxing funding requirements, sobering occupational pensions and topping of pensionable salary to €100,000, making indexation conditional, and – finally as a last resort – lowering vested pension rights and even pensions in payment from retirees. However, a new policy stance has emerged lately. After a year of hefty political debate, a new law on DC schemes was adopted in July 2016. The law makes DC schemes more attractive. It provides an attractive best-of-two worlds compromise to employees, trade unions and plan sponsors. The new DC schemes enable individual accounts, while simultaneously maintaining full cover and collective sharing of biometric risks. More importantly, the law has laid the groundwork for envisioned further changes. These aim at transferring all existing DB rights into DC rights via a nationwide effort by 2020-22. So understandably, pensions will be one of the key items in the Dutch 2017 parliamentary elections.

Jacqueline Lommen, executive director, European pensions, Robeco