INVESTMENT

Richer pickings?

It's 10 years since the onset of the global financial crisis ushered in an era of interest rate cuts, quantitative easing and meagre returns on many investments. Graham Buck **examines investment trends among European pension funds and whether any common themes are evident**

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November's quarter-point hike by the Bank of England is a step in the right direction for investors, but few expect any sharp or sudden end to the era of low-to-zero interest rates across Europe. That means meagre – even negative – returns offered by low-risk investments over recent years are likely to persist.

It's a worrying prospect, given the findings of Mercer's latest *European Asset Allocation* survey. It found that 55 per cent of nearly 600 UK defined benefit (DB) pension schemes were now 'cashflow negative' against 42 per cent last year, while 85 per cent of the remainder expect to join them by 2027.

At the same time, the de-risking trend evident in recent years has continued, with equity allocations in UK schemes halving from 58 per cent in 2008 to just 29 per cent. The survey also noted more interest in higher-yielding, illiquid assets as investors diversify equity risk and build cashflow-driven approaches.

"Rather than up-risking or de-risking, schemes have opted to expand their toolkit to include more asset classes and strategy types, including high yields and emerging-market debt and convertible bonds," reports Mercer European director of strategic research Phil Edwards. "There's also growing interest in private debt, which is less liquid than multi-asset credit.

"In Europe, the banks have stepped back from lending and created a funding gap, so there is good yield for institutional investors. While corporate bonds and government bonds have attracted investors, much of that demand has come from the central banks."

Edwards adds that recent years have also seen institutional investors becoming more global in their outlook. "Pension schemes have been part of this trend, with more investing in emerging-market debt from around 2009-10 onwards. Emerging market allocations have risen – while not suddenly or spectacularly, there has been slow and steady growth."

Changing behaviour

This autumn saw both Scottish Widows and Standard Life announce a change in investment strategy for some of their biggest UK pension funds. Scottish Widows reported that since the government's 2015 introduction of pension freedoms, it had studied customers' behaviour and the majority plan to remain invested or to take income flexibly, rather than purchase an annuity.

"To reflect their changing behaviour, we're changing our default investment strategy from targeting an annuity to targeting flexible access," Scottish Widows says. "This means that the value of customers' pensions will be gradually moved into a mix of equities, as well as bonds and cash, over the five years preceding their selected retirement date," it explains, although customers can opt out of the change.

Standard Life also plans changes, with the SL Annuity Purchase fund moving from being wholly invested in bonds to an actively-managed multi-asset fund aimed at reducing volatility. It will also keep some growth element for those wishing to remain invested.

As a result of the freedom and choice reforms, annuities have fallen out of favour in the UK. "In fact

annuities are now a small minority," Standard Life head of customer and workplace proposition Jenny Holt says.

"Therefore, we are seeing investment defaults being updated to reflect this changing member behaviour. While the long bonds used to match annuities may reduce risk for people buying annuities they may not be for others as they are more sensitive to interest rate movement and as such can be volatile."

Risk and transparency

As ever, the picture is somewhat different outside the UK. "The two main influencing factors on pension fund investment are the macroeconomic and microeconomic climates and the regulatory pressures that scheme trustees must keep in mind," comments BlackRock head of institutional business for continental Europe Christian Staub. "Clearly we're now in the ninth year of a global economic recovery that – to a great extent – is thanks to central banks buying up large quantities of corporate and government bonds.

"For scheme trustees, the big question is whether it's a good time to expand into asset classes carrying a slightly higher degree of risk, at a time when there is a push across Europe for greater levels of transparency. Companies are keenly aware that their pension liabilities must be carefully managed, to the extent that it is a major influence for many on corporate strategy."

Staub says that while this realisation is perhaps most advanced in the UK and more nascent in Germany, carmaker Daimler for example has allocated several billions to top up the funding level of its employee pension scheme over the past three years, most recently announcing a further €3 billion injection in Q4.

He identifies the interest rate environment as a key driver, with a large part of the European government curve still negative.

"Although Germany's 10-year government bond yield has now moved into positive territory it's only 0.4 per cent, while below 10 years it is still negative. European pension funds have increased their allocations to corporate bonds, emerging markets and also to some specialist asset classes, such as securitised bank loans with floating coupons. The beauty of most pension funds is that their liabilities are long term, making them the perfect investor for illiquid, long-term classes," he adds.

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BlackRock's most recent annual survey found 56 per cent of clients planned to increase their allocation to real estate in 2017, while other popular classes included infrastructure, private equity and private debt.

Staub expects socially-responsible investing to become a top topic over the next five years as society demands transparency on how asset managers decide allocations and the impact on social and environmental issues.

"Environmental, social and governance (ESG) investment will become increasingly mainstream, without any sacrifice of returns through careful analysis of companies and the selection of those that can demonstrate responsible behaviour," he adds. "The discussion is increasingly moving to investment in sustainable opportunities."

Here, the lead appears to come from the Nordics. Nordea Life & Pensions acting chief investment officer Anders Stensbøl Christiansen says: "The prolonged period of low returns means more investors than we like to believe have been pushed further out of the risk curve in the hunt for yield – without truly recognising or noticing it – because of the low volatility environment we've experienced post-crisis.

"Increased risk taking may help to stimulate the economy, and function as a new channel by which monetary policy can affect economic activities; but it could also pose challenges for financial stability.

"Various studies also provide empirical evidence that banks, money market mutual funds, and corporate bond mutual funds invest in riskier assets when interest rates are low. The hunt for yield and return sources have meant expanding the investable universe into new regions, asset classes and especially a larger allocation into alternative assets, to create an even more diversified balanced portfolio."

The growing sophistication of institutional investors and pension funds have led to more complicated set of relationships and business models, especially for private equity and infrastructure financing, he adds.

"Many institutional investors are now developing in-house direct investing capabilities and co-investing capabilities as well, where the pension fund invests directly but alongside a traditional fund investment with the purpose of increased returns and more control over their investment strategies," Christiansen explains. ■