INVESTMENT

The right direction?

As European pension funds continue to operate in the shadow of global uncertainty, high inflation and climbing interest rates, we ask what investment strategies are currently in favour across the continent

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Investment strategies at play among European pension funds are rarely homogenous, with investment teams not only having to adjust their decisions according to local pressures such as their own pension regulations or reform, but they are having to consider more than ever what's happening in the global economy.

"The current environment, and mostly the changes in the interest rate environment, have driven many of the conversations we are having with pension funds over the past few months," says WTW head of investment, Europe, David Cienfuegos. "Some funding positions have materially changed from what they were a year ago, and that has forced pension funds to reconsider whether their investment strategy is still the best strategy for them today."

State Pension Fund of Finland CEO, Timo Löyttyniemi, agrees that the economic situation is front of mind: "The biggest theme for us during the past two months has been what's happening in the US banking industry, and what the consequences of that will be for the future of financial markets overall."

Alongside this, he adds, the fund is keeping a close eye on the actions of the central banks. "Everyone is expecting inflation rates to come down, but central banks are hesitant and they need more data in order for them to change their policies."

One key impact of the rise in interest rates, says Löyttyniemi, is the attractiveness of fixed income. "Now that interest rates have risen, all fixed income investment securities are more attractive in general, government bonds included, which is a phenomenon of this year and last; and that's healthy for investment markets and healthy for investors because fixed income securities also provide hedging at times of turmoil in the market."

As a result, fixed income investments, especially investment-grade credit and sovereign bonds, says Aviva Investors head of Europe, Torben Dunkel, are "back with a vengeance" after "years of insufficient yields for the majority of institutional investors".

In the context of corporate credit investments, he adds, the decarbonisation and transitioning towards a net-zero carbon emissions economy is also gaining traction with institutional investors.

Additionally, says Dunkel, investors are considering the opportunities in real assets, with a preference currently for private debt strategies, especially real-estate debt and, with further margin improvements, infrastructure debt. "Institutional investors are also considering value-add/core+ real estate equity, to profit from the markets dislocation," he notes.

These trends, explains Dunkel, are being driven by the fundamentally changed interest rates regime, whereby markets rapidly adjusted to the inflation spike and require adequate compensation. "In that sense, they are a common sense asset allocation trade for investors, which also helps to address the denominator effect in investors' portfolios, where available quotas for private market investments have already been widely used."

Dunkel believes these trends also offer tactical and opportunity-based investing, "for investors looking for attractive relative value across the spectrum of opportunities, which has been made available by the rapid rise of assets' individual discount rates, alongside the rise of the risk free rate".

LGIM head of Europe, institutional, Volker Kurr, also notes the comeback of fixed income as an asset class in general and especially for EUR investment grade. In addition, self-indexation respectively customised indices have become much more popular, he comments, with the benefit of capturing the ESG framework of investors in a very cost efficient way. "We also note that the strong demand for private markets has come down over the past 15 months," he adds.

Again, Kurr notes the impact that interest rates are having on investment decisions: "We have seen the fastest rise in interest rates for decades, if not centuries, with double-digit negative performance in 2022 across many asset classes including fixed income. The flip side is that fixed income may be very attractive going forward."

Many pension funds, he continues, have target returns of three to four per cent per annum over the cycle. "End of 2021 asset classes like EUR investment grade had an expected return of below 1 per cent.

"Currently, it is around 4 per cent, which means that a conservative asset class can deliver expected returns and make its comeback as a core asset class."

In terms of equities, he continues to see the trend to indexing "and a substantial demand for strategies that help investors decarbonise their portfolios".

Regional differences

In terms of differences between regions, DACH, Italy and Spain, notes Kurr, are traditionally regions where allocations to fixed income are preferred, whereas regions like the Nordics traditionally have a very high equity allocation. Additionally, he remarks, the Netherlands and the Nordics are leading in ESG: "As a result, many investors develop specified sustainability objectives under an enhanced regulatory framework."

Countries going through pension reform however, like the Netherlands, are also likely to be re-visiting their strategies, says Cienfuegos: "If you have a pension scheme in the Netherlands at the moment, and you're moving from DB into some sort of DC, likely to be collective DC, what you're figuring out is, is my current investment strategy aligned to what I will need after the transition to the new system? Will the way in which I design an investment strategy be materially affected? Is my liquidity profile today in line with the liquidity profile that I might need in a DC environment? Those are the considerations."

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The pension reform in the Netherlands, says Kurr, could, for example, lead to LDI refinement, buy-and-maintain/active credit and a wider appetite for illiquid/ alternatives.

Pointing specifically to the Nordic and Benelux region, investment trends are arguably not as clear as they may have been a few years ago, where everyone was looking at private markets, argues Franklin Templeton institutional sales director, Remco van Dijk.

There are clear exceptions, he adds, with the large pension funds, both in the Nordic and Benelux regions, still looking at private markets, yet this is being done more selectively. "Real assets, and mainly infrastructure, remain to be a topic of interest."

On the private debt side, van Dijk continues to see interest, yet more, he argues, "from a barbell-perspective i.e. senior debt or (dis) stressed debt, where a few years ago, pension funds were more looking at core, middle-of-the-pack exposure".

Infrastructure, says van Dijk, is very popular from a risk/return perspective, mainly because of the inflation protection the asset class tends to offer, "and where applicable, (dis)stressed debt seems to be popular from a market timing perspective".

In public markets, specifically, he notes that the 'income' in fixed income is back, with more focus on investment grade credits, quite often with a keen eye on short(er) duration.

"Then within the equity allocation, if there is any demand, it focuses on emerging markets equity. In the Nordic region, we also see demand for climate change (article 9) funds."

Finally, in the Netherlands, explains van Dijk, regulation, sustainability and fee pressure also play a big role in investment decisions. "To give an example, regarding equity investments, active management is more expensive than passive management. Also, tracking error, is considered a 'risk' from a regulation perspective. Finally, pension funds have extensive ESG policies in place. Because of these three elements, the starting point is quite often a customised benchmark, replicate this passively."

There are also regional differences when it comes to passive versus active. "In public markets, in the Benelux, equity allocations are still mainly passive. Large fiduciary managers work with benchmark providers to build their customised benchmarks, which are replicated passively."

In the Nordic regions, however, equity allocations are still active allocations. "Here, there's more emphasis on thematics like climate change."

Looking ahead

Going forward, one major trend in the DB space, says Cienfuegos, is likely to be a transition from growth specific assets, to a focus on cashflow-generating assets, given the current funding levels compared to a year ago.

"If you are very far from your funding position and you need to incorporate into your portfolio assets that will allow you to close that gap, that's a different strategy to a position where you are looking for the type of cashflow profiling that would allow you to be more aligned to the needs of your membership and your scheme.

"That's one of the biggest changes that we're going through at the moment – how you actually transfer from, for example, a heavy, private-equity driven, alternative space portfolio to a more diverse, more cashflow-driven composition of your private markets exposure."

Finally, he concludes, ESG runs like a red line through every single conversation. "For many pension funds, the overall sentiment is, we are at a point of high uncertainty, therefore, protecting capital and having more resilient portfolios is our priority, but they acknowledge that there might also be opportunities that, selectively, they're going to pursue."

Will the conversation then focus around other aspects? Absolutely, he adds: "Big Dutch, German or Spanish pension funds are thinking, with my allocation to equities and investment grade, how are my mandates designed? Am I able to have an impact?

"They're revisiting what the equity allocation looks like, the mandate that they have with the managers. They're revisiting the credit, investment grade credit, traditional, plain vanilla portfolio, how it looks, and what the objectives are, because they probably have a new roadmap to be more impactful. That's the general theme.

"If you take it to the extreme, the net-zero pledge is a big contributor to some of these considerations. Some large pension funds who committed to that net-zero pledge are still figuring out what their portfolio needs to look like in order to meet those objectives, what the carbon journey needs to be, for them to not negatively impact their members."