Summary

- Within fixed-income portfolios, there has been a shift away from low- or negative-yielding sovereign bonds towards higher-yielding non-domestic and corporate bonds where schemes can use the cash to cover their outgoings.
- Average equity allocations across Europe have been declining, offset by a corresponding increase in allocations to alternative assets.
- European pension schemes are looking at high yield, emerging market debt, private debt and other assets with long lock ups.
- Japan is following a diversified strategy, with more allocation to bank loans, alternatives and US high yield in the fixed income space, along with major allocations to equities outside the domestic market for the first time.
- In contrast, the Netherlands is still heavily weighted towards more conventional assets.
- Target-date or lifecycle funds are popular in the US and a prominent feature of the 401K DC plan.

Setting the trend

Lynn Strongin Dodds examines the various pension fund investment trends occurring globally

Despite the differences and cultures, eking out returns in a world where interest rates are languishing at the bottom and markets continue to be erratic is challenging to most pension funds in developed markets. The recent Brexit vote has only exacerbated the volatility, making the journey that much harder, but pensions have a long road ahead and are not yet veering off their strategic courses.

Investment landscape

"I have so far not seen any material shifts in asset allocation in the US or Middle East except for in some cases, fund managers buying the dips," says BlackRock head of institutional client business in the UK, Middle East and Africa, Justin Arter. "In general fund managers do not want to do anything in a hurry and wish to wait to see things settle. One of the lessons learnt from the 2008 financial crisis was short-term relief can lead to long-term pain."

Arter's views are also mirrored in other more mature pension markets in Europe. Going forward, all eyes will be on the impact the UK's decision to leave the European Union will have on the worldwide economy and asset levels. "We think it may have a chilling effect on growth and that returns may be lower than expected and more volatile," he says. "I think what it means is that the search for yield will continue and that investments that are inflation linked and generate sustainable and secure income will be even more in the view finder."

This trend is also reflected in the recent *Mercer European Asset Allocation* survey of 1,100 institutional investors across Europe, which showed that in general, within fixed-income portfolios, there was a shift away from low- or negative-yielding sovereign bonds towards higher-yielding non-domestic and corporate bonds where schemes can use the cash to cover their outgoings.

Equity allocations

In addition, the report revealed that average equity allocations across Europe has been whittled down since the 2015 survey, although this has been offset by a corresponding increase in allocations to alternative assets. These range from real assets such as real estate, infrastructure debt and natural resources to hedge private equity and multi-asset funds.

The holdings though vary according to the regulatory constraints, the availability of acceptable alternatives, and investor risk tolerance. For example, schemes in Belgium and Sweden continue to have the highest average equity weights, versus Denmark and Germany excluding the contractual trust agreements (CTAs), which have been gaining popularity among the larger pension schemes over the last few years to fund their pension liabilities off the balance sheet. This is because CTAs that are legally separated from the sponsoring undertaking do not have restrictions regarding their asset allocation.

"What we have seen is that in the mature markets of Netherlands, UK and Ireland, de-risking continues and equity asset allocation is down," says Mercer principal Nathan Baker. "They are looking at alternatives to fill the gaps. We are also seeing this increase in alternatives in other markets, although for less-constrained investors the bond allocation fell – by 6 per cent in the case of German CTAs. Overall in Europe we are seeing schemes looking a high yield, emerging market debt, private debt and other assets with long lock ups."

Baker also notes that there is "less benchmark hugging" and a greater focus on alpha risk within the portfolios, particularly for the larger schemes. They are more likely to have the resources to extract illiquidity premia internally or hire an external manager while the smaller schemes – less than €50 million – are still using passive management, although this incorporates alternative indexation such as smart beta strategies, he adds.

Alternatives

Japan, which is home to one of the oldest populations in the world, if not the oldest, is also following a more diversified strategy. "In the past the country was mainly invested in Japanese securities," says Natixis Global AM global head of institutional sales Fabrice Chamouny. "However, government bonds are negative and we are seeing more allocation to bank loans, alternatives and US high yield in the fixed income space. We are also seeing major allocations to equities outside the domestic market for the first time."

One country that is bucking the alternative trend is the Netherlands, which is still heavily weighted towards more conventional assets, according to J.P. Morgan Asset Management EMEA head of pension solutions and advisory Sorca Kelly-Scholte. "Although we are seeing a loosening and broadening of investment strategies across Europe, the Dutch pension funds continue to invest in traditional assets, although they do look at property and infrastructure. This is because they are very focused on costs and fee structures as well as what they see as a lack of transparency, leading to an aversion to private equity and hedge funds."

The other difference is that the Netherlands is under a stricter regulatory regime – the FTK framework (Financieel Toetsingskader) framework – than many other country schemes and it has so far resisted the trend towards DC although that it is slowly changing. The pace is much faster in countries such as the UK, which over the past three years has made auto-enrolment a permanent fixture of the pension landscape and more recently lifted the lid off the annuity requirements so that people have greater choices to save or invest their retirement pots.

Investment sophistication

As for investments, target-date or lifecycle funds, which are popular in the US and a prominent feature of the 401K DC plan, are gaining traction. There is a growing array of products in the UK that differ substantially in their management costs, mixes of underlying investments and attitude to risk. Typically a series of funds is chosen to create a 'glide path' that sees the allocation strategy become less risky and equity weighted over time.

"The Dutch are under pressure to move to DC and, in general, we are seeing public policy in many countries giving individuals greater responsibility for their pension provision," says State Street Global Advisors head of European defined contribution Nigel Aston. "Markets that are more developed in Europe include Italy, where 80-90 per cent of the market is already DC. In Sweden, DC was introduced nearly 20 years ago and the country is now reviewing consolidating the options offered from around 850 funds to 10 governed portfolios. What we are seeing in these more-established markets is that fiduciaries are generally becoming more sophisticated in their asset allocation because they have scale."

Bfinance head of client consulting Sam Gervaise-Jones also notes that one of the biggest differences between pension schemes is the degree to which they can invest internally. "For example, in Australia, they have the scale to centralise decision making and do as much as possible in house," he says. This means a DIY approach to passive investing but then using the fee or risk budget to outsource the more sophisticated and illiquid strategies to specialists.

Fees

Australia, which is the fourth largest private pension market, with roughly AU$2 trillion in its superannuation, or national pension, schemes, require people to set aside 9.5 per cent of any income earned in the country into a retirement fund or a self-managed retirement investment vehicle. Like the Dutch, there is a sharp focus on costs.

"Australian Supers adopt a progressive approach to procuring asset management services and developing innovative pricing ideas that align interests," says Allianz Global Investors head of UK & Ireland Solutions team Iain Cowell. "They also have a different and more aggressive approach when it comes to performance fees. If a fund manager underperforms, there are claw-back provisions, which mean that their bonus fees from previous years must be repaid (either partly or fully)."

Diversification

In terms of asset allocation, Schroders senior strategist Sangita Chawla points out there are a variety of funds under the superannuation banner and each is designed with its own strategy. A typical allocation though is 60 per cent invested in equities, 20 per cent in fixed income and the rest is split between property, commodities and hedge funds with a bit of cash. New Zealand, on the other hand, has around four to five funds on offer catering to different risk appetites.

"Overall, we are seeing fund managers move from a narrow to broader range of assets as well as greater use of dynamic tools to change allocation in the DC space" says Chawla. "The focus is also more on an outlook-driven approach, so instead of aiming to outperform the benchmark, the goal is more for a cash-plus target, which is not constrained by the index and gives fund manager more investment scope."

Written by Lynn Strongin Dodds, a freelance journalist