Time to leave home?

Nick Reeve considers the importance of pension schemes looking beyond the domestic markets when investing

Summary
• Domestic bias within equity portfolios has decreased in recent years as pension funds have de-risked.
• There is a high level of home bias in bond and real estate portfolios, especially in liability-matching or inflation-hedging strategies.
• A global bond strategy can give investors access to deeper and more liquid markets.
• Global approaches are growing in popularity and can even be used when approaching buy-in or buyout.

Consultants and academics have long grappled with the 'home bias puzzle': investors' tendency to allocate in – or close to – their local market.

In recent years this bias has reduced in UK pension fund portfolios. According to the Pension Protection Fund's *Purple Book*, UK private sector defined benefit (DB) schemes allocated an average of just 5 per cent of their overall portfolios to UK listed stocks in 2018. This figure has halved since 2014.

While de-risking from equities into bonds plays a role in this shift, a push from consultants and asset managers towards globally-diversified portfolios has undoubtedly also led to a decline in domestic allocations.

UK private sector pension funds - proportion of portfolio invested in equities

Year	Overall equity allocation	UK listed equity allocation
2014	35.0%	10.1%
2015	33.0%	8.4%
2016	30.3%	6.8%
2017	29.0%	5.9%
2018	27.0%	5.0%

Source: Pension Protection Fund
Allocations expressed as percentage of overall portfolio. Overall equity allocation includes UK listed.

Research by FTSE Russell – based on a sample of asset owners, including pension funds – suggests that home bias still pervades in UK investors' equity allocations, however. The index provider found that UK investors allocated on average 36 per cent to domestic stocks, while the country's weighting in the FTSE All World index was just 6 per cent.

FTSE Russell's analysis found that, of five major markets studied between 2008 and 2019 – the US, UK, Australia, Japan and Canada – all had domestic

EQUITY

Country	Domestic allocation (%)	Overseas allocation (%)
Canada	30	70
Switzerland	36	64
UK	39	61
Japan	44	56
Australia	53	47
US	62	38

Source: Willis Towers Watson and MSCI

biases within their investors' portfolios. However, only American investors would have benefited from this position. For UK investors, overseas equities have performed much stronger than UK-listed stocks, driven by the depreciation of sterling.

Outside of equity portfolios, home bias is even higher. According to a 2014 research paper from MSCI, UK asset owners had 87 per cent of bond portfolios allocated to UK assets, and 92 per cent of real estate portfolios.

Barnett Waddingham associate, Sarah Lochland, says: "Unsurprisingly, where assets are being used to match liabilities – such as gilts or high-rated corporate bonds – there continues to be a strong home bias and this is something that we would expect to continue."

J.P. Morgan Asset Management's (JPMAM) head of EMEA pensions solutions and advisory, Sorca Kelly-Scholte, adds: "Statistics report the bulk of UK pension fund credit is held in sterling assets, but we tend to see more fully global credit portfolios being held by the pension funds we talk to.

"However, we do see a re-emergence of domestic bias as pension funds begin to adopt 'buy and maintain' strategies in credit, especially where part of the rationale is to match a portion of their liabilities."

While there are "stronger arguments" for retaining a domestic bias in liability hedging portfolios, Kelly-Scholte says the size of the UK corporate bond market is not sufficient to meet the demand of UK pension funds.

LDI and the path to buyout

Research by JPMAM has shown that, if all UK schemes were to allocate 5 per cent of their portfolios to liability-matching sterling corporate bonds, they would end up owning a significant proportion of the market in some maturity tranches. In the 15-20 years maturity bucket, schemes would own 36 per cent of the market, and in the 20-30 years bucket, schemes would own 40 per cent of all issuance.

Kelly-Scholte says this capacity issue will force schemes into global markets as they continue to de-risk and move towards buyout.

However, there are positive aspects of international credit exposure: the US market is much deeper and more liquid than the sterling market, bringing additional diversification benefits to funds adopting a buy-and-maintain approach.

For those preparing their portfolios for buy-in or buyout, Kelly-Scholte says trustees should not be overly concerned with moving to an all-sterling denominated portfolio ready for transfer to an insurer.

"Insurers actually have very different strategies behind their annuity books," she says. "It's not a uniform landscape by any measure and they make use of non-sterling assets."

Although there are implications for how much capital insurance companies must hold when investing in overseas assets versus domestic, Kelly-Scholte says insurers are still typically far more geographically diversified than pension funds.

"Many pension funds of course aspire to buyout in the long term but, for many, there may still be a long way to go before they get to that point," she adds. "They may face stiff competition for capacity with insurers when they get there. Ensuring robust, well-diversified investment strategies that can deliver the return needed to get pensions fund to their endgame should be as much a focus as the shape of the endgame itself."

Lochland says trustees' focus can turn towards risk management as buyout approaches. However, concentrating too much on matching liabilities can mean trustees ignore concentration risk.

"One of the key issues with a home bias is the attached concentration risk and therefore trustees will need to consider this in the context of the fund's other risks," she says.

BONDS

Country	Domestic allocation (%)	Overseas allocation (%)
Canada	98	2
Switzerland	64	36
UK	87	13
Japan	70	30
Australia	61	40
US	93	7

Source: Willis Towers Watson and MSCI

REAL ESTATE

Country	Domestic allocation (%)	Overseas allocation (%)
Canada	61	39
Switzerland	90	10
UK	92	8
Japan	95	5
Australia	81	19
US	79	21

Source: Willis Towers Watson and MSCI

"The UK fixed income market is dominated by a few sectors, particularly for longer-dated assets. This likely leaves a portfolio that has a bias towards domestic assets, while incorporating global assets to control the concentration risk."

Real estate and infrastructure

In the 2014 MSCI paper, researchers Jean-Martin Aussant, Peter Hobbs, Yang Liu and Peter Shepard state that the "traditional, home-biased focus of real estate investing is starting to change".

"Many investors have started to understand the role of real estate in a multi-asset-class context," they write, "and this perspective tends to increase the demand for international real estate, furthering the decline of real estate home bias."

However, with investors often keen to hedge against inflation risk, property and infrastructure assets are growing in popularity, with investors keen to buy rental income that can increase in line with RPI or CPI.

In addition, in recent years politicians have urged pension funds to consider allocating more to domestic infrastructure assets to supplement government funding. A 2019 government consultation paper on illiquid assets in defined contribution (DC) schemes looked at how to help DC investors access these kinds of assets, among other considerations, while local government pension schemes have been active in investing in local infrastructure projects and social housing.

However, Kelly-Scholte points out that rental income streams are not as aligned with inflation as many people think, with a correlation of 0.39 for the period since 2006. Pressure on traditional retail property from online-only competitors and the rise of rented office providers such as WeWork and Regus have changed the dynamics of the property market, particularly in major cities.

"In property, the empirical evidence that UK real estate is correlated to UK inflation may similarly be weaker than intuition suggests," says Kelly-Scholte. "Including and since the financial crisis, UK property has had a lower correlation to UK inflation versus European, US or even Asia Pacific property.

"Other influences, such as supply/demand dynamics, seem to have the greatest impact on UK property returns.

In fact, this appears to be true in each region, with a generally low correlation of core domestic property returns to inflation in its domestic market."

Instead, Kelly-Scholte says she expects global approaches to increase in popularity as investors understand that they are not getting as much inflation protection as they had hoped.

Lochland says global real estate funds can be a useful tool for pension funds seeking to gain exposure to core property in developed markets. Investors can access directly through mutual funds or indirectly through listed real estate operating companies or real estate investment trusts.

The most suitable approach will depend on a pension fund's view on factors such as equity risk, currency risk and liquidity, Lochland says. However, she warns that trustees should be aware of regional differences across property markets when targeting inflation protection.

"Differences in economic cycles may mean that inflationary increases differ significantly between regions," she says. "We would normally expect pension funds to hold global property as a way to boost expected returns and provide diversification, rather than to provide inflation protection."

Infrastructure – a hot topic among pension investors over the past few years – can often be dominated by political risk, Lochland says, making global portfolios a better diversifier than domestic funds.

Home bias may seem a small risk in the context of pension funds' risk management agendas, particularly when solely focusing on equity portfolios. However, connected risks such as concentration in sectors or a lack of inflation protection can lurk in non-equity allocations. A global approach to all major asset classes is a necessary consideration for all investment strategies.

UK allocations to domestic/overseas assets

Asset class	Domestic allocation (%)	Overseas allocation (%)
Equities	39	61
Bonds	87	13
Real Estate	92	8

Source: Willis Towers Watson and MSCI

Written by Nick Reeve, a freelance journalist