Growing globally

Laura Blows looks at the size of the pension market worldwide and how its asset allocations are changing

Summary

- Pension funds now account for approximately $60.6 trillion in assets globally.
- There is a high level of concentration, with the top three pension markets (US, UK, Japan) accounting for 75 per cent of all pension assets.
- The total pension assets to GDP ratio for the top 22 pension markets was 76.3 per cent at the end of 2021.
- DC assets have grown by 8.2 per cent per annum over the past 20 years, compared to DB assets growing by just 5.1 per cent.
- The top seven pension markets were 45 per cent invested in equities in 2021, 34 per cent in bonds, 19 per cent in other, and 2 per cent in cash.
- The asset allocation to real estate, private equity and infrastructure grew from about 7 per cent to above 26 per cent over 20 years.
- Greater clarity on sustainability-related investment actions is expected in the future.

Accounting for $60.6 trillion in assets, out of the $175 trillion assets owned globally, pension funds certainly are a powerful collective force on the global investment stage.

Only mutual funds (including ETFs) have a bigger piece of the pie, at 63.1 trillion, the Thinking Ahead Institute's *Global Pension Assets Study 2022* (GPAS) finds. At $40.3 trillion, insurance funds came a respectable third.

Countries' pensions assets size

As just 22 pension markets (P22) in the world make up $56.58 trillion of pension assets, the study has homed in on these markets, and within this, the seven markets (Australia, Canada, Japan, Netherlands, Switzerland, UK and US) that make up 92 per cent of this total, at $52.2 trillion.

Delving further, the top three pension markets represent 75 per cent of all pension assets. The top market alone, the US, holds a staggering 62 per cent of the total P22 assets. The UK recently overtook Japan to become the second largest pension market, holding 6.8 per cent and 6.5 per cent respectively.

Over the past decade the US has increased its weighting, up from 52.2 per cent, while the UK's and Japan's decreased from 8.5 per cent and 12.7 per cent respectively. In contrast, the weights of Australia, China, Hong Kong, Netherlands, South Korea and US have increased relative to other markets in the P22 over the past decade.

Speaking at the study's launch in February, Thinking Ahead Institute researcher, Samar Khanna, stated that there was "not just concentration between markets but also within markets".

He gave the examples of Japan, with its GPIF, the largest pension fund in the world, owning 46 per cent of Japan's pension assets. While in the UK, the top 10 pension funds accounts for 60 per cent of total UK pension assets.

The *GPAS* finds Australia to be the most successful pension market over the past 20 years, seeing pension asset growth versus market returns of 11.3 per cent per annum, in USD terms, compared to the P22 countries generally seeing 6.8 per cent asset growth in that time. Australia's asset size was $2.8 trillion in 2021. In 2011 it was $1.4 trillion and in 2001 it was $270 billion.

The size of the US' pensions assets grew from $9.7 trillion in 2001 to $15.3 trillion in 2011 and $35 trillion in 2021. Meanwhile, the UK's asset size increased from $1.1 trillion in 2001, to $2.5 trillion in 2011 and $3.8 trillion today, and Japan's changed from $2.1 trillion in 2001, to $3.7 trillion in 2011 and $3.6 trillion today. The Netherlands saw growth of $2.2 trillion in 2021, from $1.1 trillion in 2011 and $433 billion in 2001.

Reasons for growth

The *OECD Pension Funds in Figures* June 2021 report tells a similar tale, finding that despite the shock of Covid-19, pension fund assets rose in 2020 by nearly 9 per cent in the OECD area – although less than the double-digit growth rate in 2019 – to reach $34.2 trillion at end 2020.

Pension fund assets continued to rise in 2020 in almost all countries, the OECD finds, "supported by capital gains in financial markets and government measures that helped members to continue participating in their pension plans".

It highlights that some of the strongest asset rises in nominal terms occurred in Georgia (over 100 per cent) where participation in a second pillar pension scheme has become mandatory since 1 January 2019, and in France (84 per cent), where insurance companies have started creating and transferring pension business to FRPS (a newly authorised vehicle that is a pension fund).

"Since the global financial crisis, the global economy has been buoyant, with corporates performing strongly and asset markets providing strong returns for investors. In this environment pension fund investments have steadily increased, but more relevantly, employer schemes have seen large contributions pumped into pension pots," Kempen Capital Management co-head investment strategy UK, Arif Saad, says.

"This has been a function of solid balance sheets, but also a function of government mandates forcing employers to do so. Regulation, enforced funding provision and greater protection for pension members has pushed up the size of global pensions as governments want less reliance on state pensions going forward. This trend is not likely to end soon with policies such as auto-enrolment in the UK and the growing superannuations in Australia showing the direction of travel," he explains.

Pension assets relative to GDP

As the amount of pension assets grows, so does the size of the pension assets relative to GDP. In fact, total pension assets to GDP ratio reached 76.3 per cent for the P22 markets at the end of 2021, the *GPAS* finds.

According to the report, the Netherlands has the highest ratio of pension assets to GDP at 213 per cent, followed by Australia (172 per cent), Canada (170 per cent), Switzerland (157 per cent), the US (153 per cent) and the UK (124 per cent).

During the past 10 years, the pension assets to GDP ratio increased the most in the Netherlands, Australia, Switzerland and the US (94, 79, 64 and 54 percentage points respectively). It declined only in Ireland (and that by 1 percentage point).

The OECD's report also notes significant differences across countries between the level of assets in pension funds relative to the size of the domestic economy.

It finds that, in 2020, assets exceeded GDP in five countries – the Netherlands (210.3 per cent), Iceland (194.3 per cent), Switzerland (149.1 per cent), Australia (128.7 per cent) and the United Kingdom (118.5 per cent). In contrast, pension fund assets remained much smaller in countries such as Albania, Greece and France, accounting for 0.2 per cent, 1 per cent and 2.6 per cent of GDP respectively.

However, it notes, in some countries, retirement savings are accumulated in vehicles other than pension funds, such as provisions in employers' books (eg in Austria, Germany, Sweden) or pension insurance contracts (eg in Belgium, Denmark, France, Sweden).

"For example, more assets were accumulated in Belgium, Denmark, France and Latvia in these other vehicles than in pension funds in 2020. Denmark has the largest amount of pension assets relative to GDP when considering the whole funded private pension system (238.9 per cent of GDP)," it states.

According to Columbia Threadneedle Investments head of pensions and investment education, Chris Wagstaff, expressing the size of a nation's accumulated pension assets to its GDP provides a "simple, high-level comparator by which nations of various sizes and varying pension structures can compare the relative size and perceived strength of their occupational (second pillar) pension systems against a common benchmark".

However, he states that while the pension assets to GDP ratio's greatest strength is its simplicity, "this is also its greatest weakness".

"For instance, despite active DC membership in the UK now far outstripping active DB, the sheer size of legacy DB benefits means UK pension assets are split 80/20 in favour of DB," Wagstaff says.

"However, the UK's, DB asset-heavy, 100 per-cent-plus ratio tells us nothing about the gaping pensions gender gap, or the resultant intergenerational inequality that arises from the rapid transitioning from the generosity of DB to the relative parsimony of DC.

"Equally, the pension assets as a percentage of GDP ratio doesn't capture the UK's immense unfunded (off-balance sheet) liabilities of the gargantuan NHS and uniformed services occupational pension schemes or tell us anything about the quantum or sustainability of the UK's (first pillar) pay-as-you-go state pension system, or the rising pension poverty rate associated with increases in the state pension age."

He notes that for those countries whose occupational pensions are predominantly funded DB (eg Netherlands) or DC with high mandatory contribution rates (eg Australia), ratios far in excess of 100 per cent have long been commonplace.

"However, for those that are largely DC, where contributions levels are not mandated (eg Italy) or where unfunded DB is commonplace (eg Germany) or where occupational pensions are not mandatory (eg Ireland), a ratio of less, often far less, than 100 per cent is more common."

DC growth

Thinking Ahead Institute co-founder, Roger Urwin, also shares concerns. He noted at its study launch in February that while it is "very good" that pension assets growing to record levels, "it is not that big overall … with fiscal tightness going forward there is really going to be more growth in wealth management than pensions going forward. So, this growth is there but it could be bigger... That is not a great pensions outcome for the world because the average DC pot as a result of that is surprisingly small. We need to have multiples of GDP really in the pensions system if it is going to work".

The *GPAS* finds that over the past 20 years, the number one pension scheme design is DC, DC assets having grown by 8.2 per cent per annum, while DB assets have grown at 5.1 per cent per annum.

For some examples, Australia has seen its DB/DC asset split change from 20/80 10 years ago to 87 per cent DC in 2020. In the US, the portion of DC scheme assets over the past 10 years has increased from 57 per cent to 65 per cent. In contrast DC scheme assets account for only 5 per cent in both Japan and the Netherlands.

Asset allocations

According to Wagstaff, the pension assets/GDP ratio's upward trajectory is "principally attributable to the strong investment returns from both equity and fixed income markets over the past decade relative to GDP growth".

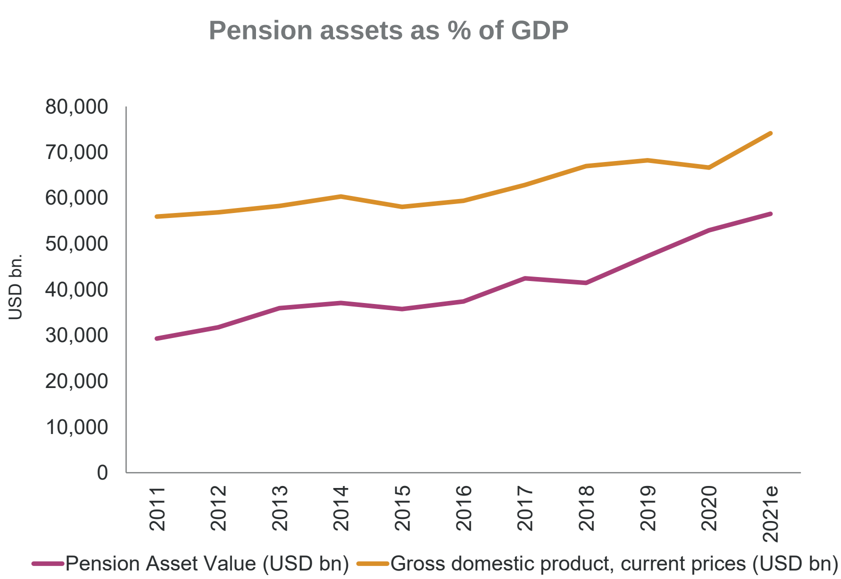
"Indeed, whereas GDP in most developed nations has grown, in real terms, on average, by around 2 per cent per annum, real returns from risk assets, such as equities, have until very recently, far exceeded their long-run average of 4-4.5 per cent per annum. Likewise, fixed income returns. This, in turn, has flattered the apparent health and implied outcomes of many pension systems, not least in the UK, disguising both the sub-par level of DC contributions and the often sub-optimal decision making and resulting outcomes when accessing accumulated DC benefits," he states.

The OECD report finds that, in 2020, equities and bonds accounted for 74 per cent of pension fund investments on average in its 68 reporting jurisdictions, with bonds representing 50 per cent of pension fund investments.

The *GPAS* finds similar among its P7 countries. In 2021 they were 45 per cent invested in equities (a decline of 16 per cent since 2001), 34 per cent in bonds (a 2 per cent rise), 19 per cent in other, and 2 per cent in cash.

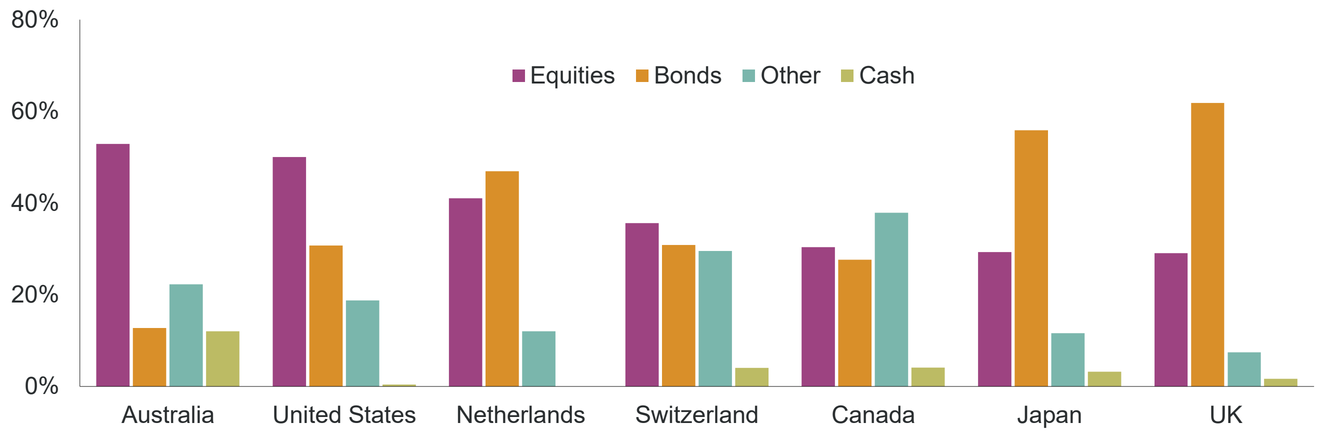
Asset allocations to real estate, private equity and infrastructure in the 20-year period saw the biggest growth, from about 7 per cent to above 26 per cent, the study finds.

However, as Khanna says, these figures hide some big dispersions, giving the examples of the US having above-average investments in equities, at 50 per cent, and Australia 53 per cent, while others like the UK, the Netherlands and Japan having above-average bond



Source: Thinking Ahead Institute and secondary sources

Pension scheme asset allocation in 2021



Source: Thinking Ahead Institute and secondary sources

allocations, at 62 per cent, 47 per cent and 56 per cent respectively.

The OECD also highlights this discrepancy, noting that equities accounted for more than 50 per cent of pension investments in Hong Kong (China), Lithuania, Malawi, Namibia and Poland in 2020, while pension funds invested almost none of their assets in equities in Armenia, the Czech Republic or Georgia.

Saad also notes that "the unique and unintended consequence of government behaviour is that pension schemes have now become one of the largest holders of government bond assets globally".

"These asset owners are indifferent on price and have only bought these bonds because they are the 'risk-free asset' for their pension scheme. In part, this has resulted is the negative yield investors receive from buying real government bonds in the UK and Europe," he explains.

"This inefficiency due to mispriced markets can only lead to a misallocation of assets. The winners from this are the government – they have a large and stable owner of current bonds, and if they need to issue more debt, they have a ready and willing buyer. This has resulted in lower funding costs due to lower bond yields. The loser in this equation are the corporates – they continue to use profits to pump up pension schemes who buy assets at negative yields. Counterintuitively this can only result in a negative outcome for the economic environment, and therefore GDP, as profits are not spent on further growth, research and development or dividends to shareholders," Saad warns.

A sustainable future

However, on a more positive note, Saad states that "as pension schemes have become larger holders of investment assets globally, the benefit has been greater engagement as many schemes are no longer happy being passive owners. Active ownership by investors has resulted in increased voting on company management actions, and in many instances a greater focus on environment, social and governance factors. This means that not only is there a link between pensions and GDP, but also on a more holistic measurement of growth in the global economy".

WTW global head of research, Luba Nikulina, speaking at the *GPAS* launch, noted that more work needs to be done for pension investors to feel more comfortable investing sustainably, without risking clashing with their fiduciary obligations.

"Generally there is broad agreement on what sustainability looks like, and its relation to ESG factors and social development goals, but there isn't complete consensus on how to implement investment portfolios to achieve these aims," Quantum Advisory principal investment consultant, Paul Francis, says.

"For example, is it better to divest from fossil fuel companies now or to continue to invest in them to help support their transition to carbon neutrality, which is necessary if carbon reduction is to be successful."

These concerns may be resolved in the future, as the *GPAS* predicts a growing demand from regulation, stakeholders and society calling for greater clarity on sustainability-related actions as a theme for 2022.

"It is time for the investments industry to translate net-zero announcements into concrete strategies. Greater accountability from asset owners will drive change in the rest of the investment value chain. The rise in benchmarking and standardisation will place a limit on greenwashing and overclaiming. Growing legal and regulatory pressures produce further reinforcement for accountability," it states.

As Urwin said at the *GPAS* launch, the global pensions market is currently at a "fork in the road"; with pension funds increasingly walking down the sustainable investing path.

Written by Laura Blows