Back to long-term investing in the age of geopolitical risk

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Amundi
ASSET MANAGEMENT

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Foreword

Today, investors face cross-winds from diverse sources. Central banks are winding down their unorthodox monetary policies. Governments are less hesitant about deficit spending. Populism is on the rise. Geopolitical tensions are lurking in the background. Thus, the global economy is braced for various shifts that are laced with layers of uncertainty. This is the first survey of its kind to look at the nature of the shifts and their consequences. It also shows how pension plans – in this turbulent age – are adapting to the unfolding reality.

As ever, in uncertain times, the dominant tendency is go back to basics. As this decade has progressed, long-term investing has been sidelined, as asset prices have increasingly deviated from their 'fair value'. However, long-term investing is likely to stage a comeback, as investors transition to a new regime where prices gradually reconnect with their fundamentals as volatility rises. The report also turns the spotlight on how ESG investing and long-term investing are morphing, as pension investors increasingly price in climate change and other long-term risks.

We are pleased to partner with CREATE-Research in this series of annual surveys that look at emerging challenges in the pension landscape and the responses they require. As a regular independent writer on investment management over the past 20 years, Amin Rajan has produced another insightful report on how pension plans are responding to momentous events in the global economy with diligence and patience. We at Amundi hope that you will find the report informative.

Pascal Blanqué

Group Chief Investment Officer
Amundi

Acknowledgements

"We never take the one-year figure seriously.

After all, why should the time required for a planet to circle the sun synchronise precisely with the time required for business actions to pay off?

Instead, we recommend not less than a five-year test as a rough yardstick of economic performance."

Warren Buffett

This insight is as relevant today as it was at the dawn of investing – if not more so.

The rise of populism casts a political shadow over the global economy at a time when central banks are starting to unwind their highly accommodative monetary policies. Their combined effects are likely to cause major shifts in the global economy.

This report presents the views of pension plans on the prospective macro shifts and their impact on asset allocation.

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My foremost thanks go to the 161 pension plans who participated in our survey. Many of them have provided unstinting support over the years. Their invaluable insights have enabled me to add colour and nuance to the data presented here.

I would also like to thank Amundi Asset Management for supporting the publication of this report without influencing its findings in any way. This arms-length relationship has enabled me to present an impartial assessment. The report is richer for that.

Special thanks also go to IPE for helping to conduct the survey and especially to its editor Liam Kennedy for his inspirational support towards this annual Amundi-CREATE series over the past four years.

Finally, I would like to thank two colleagues at CREATE-Research: Lisa Terrett for her help during the research phase and Dr Elizabeth Goodhew for her editorial support.

If, after all the help I have received, there are errors or omissions in this paper, I am solely responsible.

Amin Rajan

Amin Rajan

Project Leader
CREATE-Research

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Introduction and aims

A sunny outlook with cloudy skies. That's how investors see their current investment prospects.

Economies in America, Europe and Japan have finally reached escape velocity: the worst of the 2008 global financial crisis is now in the rear-view mirror. The US Federal Reserve has also started its long-heralded policy normalisation. Markets continue to flirt with their all-time highs.

But investors remain nervous as unfamiliar political risks have emerged. The Brexit vote, the election of Donald Trump and the recent unexpected gains by the far-right nationalist AfD party in Germany mark the rise of a long-forgotten phenomenon: populism.

"Populist parties have rapidly become electable, gaining seats in 10 out of the last 11 general elections."

An interview quote

Such a historic shift is always hard to discern at the time. Markets struggle to price its inherent risks until they materialise.

Populism is not a passing phenomenon but a structural feature of societies in which the gains of globalisation have been shared unevenly: a situation accentuated by quantitative easing by key central banks in this decade.

Populism has sparked fears of rising trade protectionism and competitive devaluations. On the flip side, however, it may also boost growth and jobs via strong fiscal stimulus and business-friendly deregulation, while releasing inflationary pressures.

These developments herald four potential shifts in the global economy:

- from globalism to populism
- from monetary to fiscal policy
- from deflation to inflation
- from over-regulation to deregulation.

Against this background, this survey report presents an assessment of European pension plans on five pertinent issues:

- how likely are these potential shifts?
- how will they affect asset allocation approaches?
- what is the future of long-term investing in this era of change?
- can ESG deliver robust portfolios to cope with the associated volatility?
- how can asset managers help their clients navigate the promise and perils of the emerging regime?

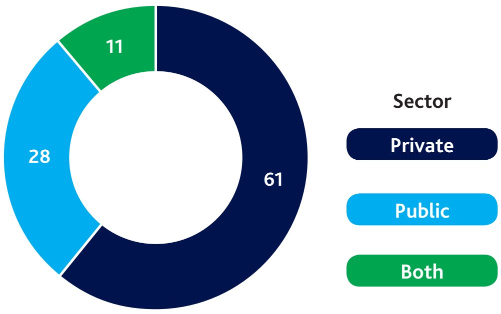
These questions were covered in a pan-European survey involving 161 pension plans, with total assets of €1.71 trillion.

The survey was followed up by interviews with 30 senior executives to obtain detailed insights. The survey background is given in the figures below. The hybrid plans mentioned therein blend certain features of both DB and DC plans.

Our headline findings are given on the next two pages followed by six themes that expand on them.

What sector does your pension plan cover?

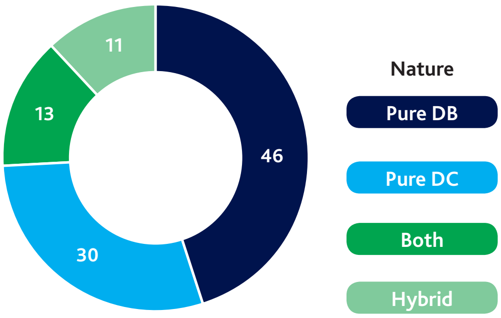
% of survey respondents



Source: Amundi Asset Management / CREATE-Research Survey 2017

What is the nature of your plan?

% of survey respondents



Source: Amundi Asset Management / CREATE-Research Survey 2017

Headline findings

1. The winds of change are evident

The turbo-charged globalisation of the past 25 years is giving way to a new age of beggar-thy-neighbour populism.

This is happening while central banks are winding down their quantitative easing, leaving fiscal action to pick up the baton to sustain global growth. 2017 is the first year in a decade in which no advanced economy is experiencing deflation.

History shows that seldom do such shifts appear material at the time. But they can be hugely consequential in hindsight.

Hence, financial markets are bracing themselves for four shifts. History shows that seldom do they appear material at the time. But they can be hugely consequential in hindsight.

When asked how likely they are to occur over the next three years, the majority of our respondents consider them either '*very likely*' or '*maybe*', meaning possible. (Figure 1.0).

Their outcomes could go either way.

The shift from monetary policy means that markets could revert to their fair value. But might a premature rate rise start a 1937-style collapse? Woe betide the central bank that causes it.

After all, the global economic recovery has yet to generate the earnings boost that could justify the current over-stretched asset valuations.

Similarly, the shift towards populism, driven by the fiscal and trade agendas of President Trump, could boost growth and jobs in the US. But the gains could be negated by strong retaliation.

For investors, the near term is no more than a journey of twists and turns. All they know is that they are transitioning from a long period of asset reflation to a more mature phase of the market cycle.

Theme 1 provides more detail (p.5)

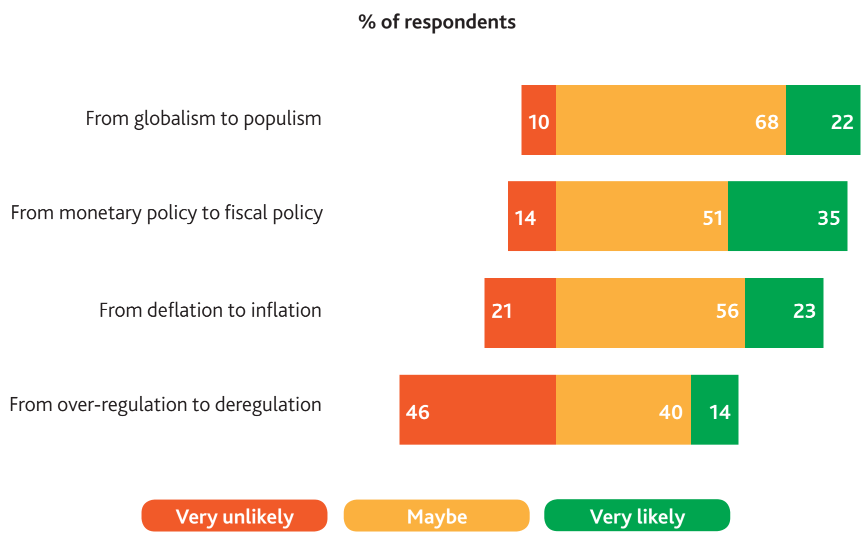
2. Back-to-basics will dominate asset allocation

Unsurprisingly, for 95% of the time, our respondents appear to worry about big market events that occur 5% of the time. They fear volatility spikes.

Timing the markets will remain a fool's errand. Instead, pension plans will aim to build portfolios that are resilient to fat-tail events, capitalise on periodic market dislocation and use bottom-up asset picking to add value.

To achieve that, they will overly rely on: diversification based on risk factors, absolute return investing, buy-and-hold investing, and the power of mean reversion. Their approach will favour two asset classes: equities and alternatives.

Figure 1.0 How likely are the following shifts in the global economy over the next three years?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Pension plans are likely to extend their asset-holding periods to allow more time for risk premia to materialise.

In equities, the emphasis will be on cash-flow compounders that are viewed as *bond surrogates* due to their good dividend, good pricing power, high brand loyalty and strong balance sheets. At a time when longevity risk is on the rise, equities are also deemed to be providing an unlimited upside to tackle it. In contrast, bonds only offer a coupon.

Global equities, European equities and emerging market equities are likely to be most favoured; the US equities less so, due to their perceived over-valuation.

As for alternatives, real estate, alternative credit, infrastructure and private equity are likely to be most favoured, as pension plans are obliged to adopt longer time horizons.

Fixed income may well lose its glamour, because the 35-year bull market in bonds is coming to an end, with more rate rises promised by the Fed. Familiar havens are no longer a place of safety.

Themes 2-3 provide more detail (pp.6-7)

3. Long-term investing has become a matter of necessity as much as choice

There is clear recognition that in the world of the 24-hour news cycle, it is easy to get preoccupied with the here and now and miss the bigger picture.

Depending upon how various risks from the identified shifts pan out, markets could get as volatile as during 2010-13, when the Eurozone crisis left them directionless for extended periods.

To cater for that possibility, pension plans are likely to extend their holding periods to allow more time for risk premia to materialise.

'Time in' the market will matter more than 'timing' the market. The emphasis is on remaining invested in quality assets, so as to gain more by losing less and outperforming over a full cycle. Hence, 44% of our respondents expect the role of long-term investing to '*rise*', 48% expect it to '*remain unchanged*' and 8% expect it to '*fall*'.

Theme 4 provides more detail (p.8)

4. ESG is going from niche to mainstream

As part of the rise of long-term investing, 61% of our respondents expect to raise their allocations to the ESG theme, from the current average level of 36%.

A hard-nosed approach to ESG investing is evident. It aims to manage reputational risk, earn competitive returns, manage newly emerging climate change risks that are hard to model and deliver tangible societal impacts.

ESG investing is now part of a new narrative: sustainable long-term returns require a sustainable economy and society. What matters is not just a return for today or tomorrow but also for the next 25 years, when liabilities fully mature.

The rise of populism has all too clearly exposed the harmful side effects of globalisation: social instability, loss of skilled jobs and environmental damage. ESG investing will continue to have a moral as well as an economic purpose: both go hand in hand when delivering pensions over distant horizons.

Theme 5 provides more detail (p.9)

5. Asset managers need new capabilities for a new regime

As pension plans face the emerging shifts, they have to perform a balancing act between dialling down risks to cope with heightened volatility on the one hand, or missing out on one of the longest bull markets in history on the other. '*Wrong time*' risk and '*regret*' risk are both lurking in the background.

To help manage them and deliver decent returns, pension plans want their asset managers to do three things.

First, deepen and broaden investment expertise to identify new risks and manage them.

Second, stress test their strategies over multiple scenarios and time horizons.

Third, improve the alignment of interest with a more equitable structure of fees and charges that reflect value added.

Theme 6 provides more detail (p.10)

Theme 1 Policy mis-steps and market pull-backs are inevitable

In order to control volatility and keep a floor under asset values, central banks may be trapped in a QE cycle for ever.

When asked to assess the impact of the identified shifts on the financial markets, our respondents offered a qualified assessment (Figure 1.1). Taking them in turn, 27% believe that the shift from monetary to fiscal policy will have a '*positive*' effect, 62% believe it will have a '*mixed*' effect, meaning it could go either way. The remaining 11% expect a '*negative*' effect.

Central banks in America and Europe are keen to unwind their unorthodox policy stimulus, now that they are close to the point of diminishing returns. Another unspoken catalyst is their desire for more room to manoeuvre in the next recession, having exhausted all policy bullets by now.

However, it is doubtful whether policy normalisation will be orderly. The scope for timing errors is huge, due to the uncertainty around the Trump agenda. Besides, in order to control volatility and keep a floor under asset values, central banks may be trapped in a QE cycle forever. Premature rate rises could turn what has been a stabilising force into a destabilising one.

Moving on to the second shift, from over-regulation to deregulation, 37% think the effect will be '*positive*', a further 52% cite it as '*mixed*' and the remaining 11% as '*negative*'.

In so far as deregulation genuinely reduces bureaucracy for businesses and promotes enterprise, it is to be welcomed. However, there are concerns that, in the US, it may go too far and create conditions for the next crisis.

Moving on to the third shift, from deflation to inflation, 32% expect the effect to be '*positive*', 51% to be '*mixed*' and 17% to be '*negative*'.

For the first time since the 2008 crisis, the dark shadow of deflation is receding in the developed world and the tide is shifting towards inflation.

However, its pace cannot be over-estimated. The rising global debt level, at an all-time high of 325% of global GDP in 2016, remains one source of deflationary bias. The other is aging demographics.

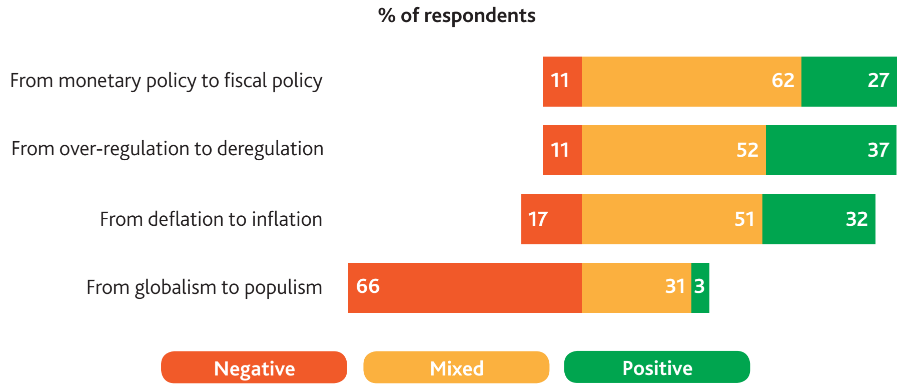
As for the final shift, from globalism to populism, only 3% expect it to be '*positive*', 31% to be '*mixed*' and 66% to be '*negative*'.

The biggest concern is that the Trump agenda on trade and protection – if pursued vigorously – could be an 'own goal' for America and the rest of the world, via elaborate financial and supply chain linkages. The global economy is far from robust: a significant negative shock could send it into a new tailspin.

The net result of these shifts is hard to assess. Higher volatility is the only certainty.

Section 2 provides further details (p.11-18)

Figure 1.1 **How would you describe the overall likely outcomes of the shifts for financial markets over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Punitive unilateral tariffs on Chinese and Mexican goods will spark retaliation that will only result in higher inflation."

"Central bank action is generating diminishing returns. The days of high returns/ low volatility are over."

Theme 2 Asset allocation will blend caution with opportunism

While markets could go even higher, headwinds are building as tailwinds may be dissipating.

To prepare for the potential shifts, pension plans are likely to put more emphasis on capital conservation and less on capital growth (Figure 1.2, left chart).

The following goals will become '*more important*', according to the survey:

- capital conservation (61%)
- high income (54%)
- regular cash flow (40%)
- capital growth (19%).

The results reflect the widely held view that while markets could go even higher, headwinds are building as tailwinds may be dissipating. Pension plans have to prepare for a world where the unexpected could happen.

Another reason for the implied caution is that only 25% of our respondents have implemented plans for the potential shifts (Figure 1.2, right chart). Nearly 56% are either in the 'awareness raising' stage or remain 'unsure'.

Over the rest of the decade, certain asset allocation tools, investment vehicles and investment strategies are likely to gain much more prominence amongst at least a third of our respondents, as shown in Figure 2.2 (p.15).

The key asset allocation tools include:

- diversification by risk factors (60%)
- absolute return investing (53%)
- buy-and-hold investing (51%)
- dynamic investing (44%).

The investment vehicles, in turn, include:

- multi-asset class products (40%)
- smart beta funds (31%).

Notably, cap-weighted indices are likely to receive least attention, owing to their strong price momentum that can be very detrimental during big market corrections.

Finally, the investment strategies include:

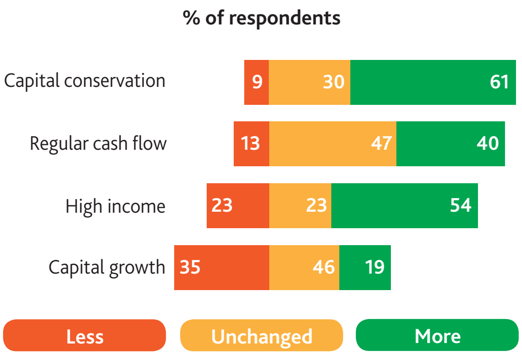
- real assets (72%)
- theme funds (e.g. ESG) 52%
- alternative investments (50%)
- bottom-up asset picking (47%).

Fears of bear markets remain subdued – for now. In the past, market routs occurred when rates were pushed up overzealously, or when economic growth and corporate profits were pushed into bubble territory. These conditions are not so evident now. But all eyes are on the Trump agenda and US monetary easing. Much hangs on how they pan out.

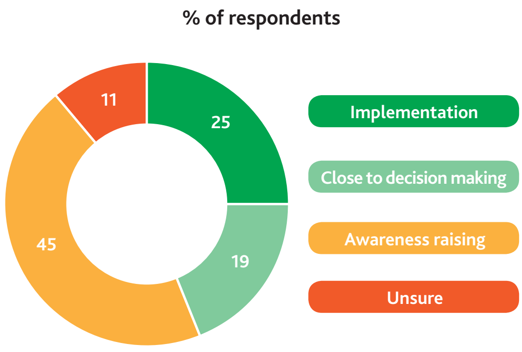
Section 2 provides further details (p.11-18)

Figure 1.2

How will the importance of the key goals of your pension plan change, as and when the shifts materialise over the next three years?



While planning your pension plan's response to potential shifts, in which stage is your pension plan currently?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Over US$10.5 trillion of sovereign and corporate debt still trades at a sub-zero yield."

"A beautiful normalisation of monetary policy remains a pipe dream."

Theme 3 Equities will experience gravitational pull

Markets seem to assume the best about the future policies of central banks in general and the Trump administration in particular – so far. But the downside risks cannot be underestimated. For investors, the outcomes range between booming markets where fundamentals drive asset prices again at one end; and major slides at the other.

Pension plans are enjoined to hold two opposing ideas in mind at the same time and act as if both are equally likely.

Pension plans are thus enjoined to hold two opposing ideas in mind at the same time and act as if both are equally likely. Three considerations will influence their asset allocation over the rest of the decade.

First, there will be a continuing '*bondification*' of equities. Equities are expected to deliver better total returns than bonds - if held over a longer period of time. They will offer value opportunities (Figure 1.3, north-west segment) provided future corporate earning rises compensate for the negative effects from rate rises.

Overall, non-US equities are likely to outperform US equities, which have priced in the potential upsides from three sources: the Trump agenda, rate hiking cycles and corporate earnings.

Second, alternative assets will be favoured to harvest illiquid long-term premia (Figure 1.3, north-east segment). They are seen as viable hedges against inflation and interest rate risks, while delivering uncorrelated returns. They have become an attractive destination for yield-hungry investors even though their expected returns are likely to be lower, due to rising uninvested '*dry powder*' seeking of viable opportunities.

Third, with the long-running bull market in bonds coming to an end with rate rises, fixed income assets are perceived as either overvalued or exposed to value traps (Figure 1.3, lower half). The US credit cycle is more mature and in a late stage of expansion.

Pension plans will remain keen on reducing credit risk and duration.

Section 2 provides further details (p.11-18)

Figure 1.3 **Which asset classes are best suited to meet your plan's needs over the next three years?**

Top 10 choices

Risky Assets (left) / Hedging Assets (right)

Value opportunities	% of respondents	Fair value	% of respondents
Global equities	62	Real estate (debt)	52
Private equities	49	Alternative credit	51
European equities	49	Infrastructure	50
EM equities	44	High quality equities	47
		Investment grade corporate bonds in Europe	31
		Hedge funds	17

Value traps	% of respondents	Overvalued	% of respondents
EM government bonds	23	High yield bonds	27
Investment grade corporate bonds in US	23	Real estate (equity-based REITS)	27
Small cap equities	20	Investment grade corporate bonds in EM	21
US equities	11	European government bonds	19
		Domestic equities	14
		US government bonds	14

Bottom 10 choices

Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Equities are more valuable since their total returns will be higher than those of bonds as rates rise."

"It's hard to know what to make of the current flat US yield curve. Has it lost its predictive charm?"

Theme 4 Long-term investing is an idea whose time has come again

Long-term investing has come to the fore as political events and their impacts have proved difficult to predict.

Before the dawn of populism, as excess liquidity bloated asset prices without stoking inflation, pension plans' interest in long-term investing had waned somewhat.

When asked how the length of the period used in defining long term has changed in the past five years for three broad asset classes, the responses were:

Equities: '*increased*' 21%, '*decreased*' 24%. The rest replied '*unchanged*'.

Bonds: '*increased*' 17%, '*decreased*' 31%.

Alternatives: '*increased*' 21%, '*decreased*' 16%.

However, with the rise of populism, sentiment has duly shifted (Figure 1.4). 44% now report that the importance of long-term investing will '*rise*', 48% expect it to remain '*unchanged*' and only 8% expect it to '*fall*'.

Underpinning these results is the belief that lower portfolio turnover will deliver better results and lower costs. Long-term investing has come to the fore as political events and their impacts have proved difficult to predict.

The implied support for buy-and-hold investing does not necessarily mean hanging on to a position, come what may. For example, for equities, it means ensuring that current valuations factor in the fundamentals. If the current price is higher than the discounted price, the asset may be sold and only repurchased when the situation is reversed.

Such pragmatism also holds that asset class diversification is not the only way to avoid losses on equities during periods of market stress. Longer holding periods can also allow these losses to be offset against subsequent gains when mean reversion kicks in – so long as there is an exit strategy to cope with big market slides.

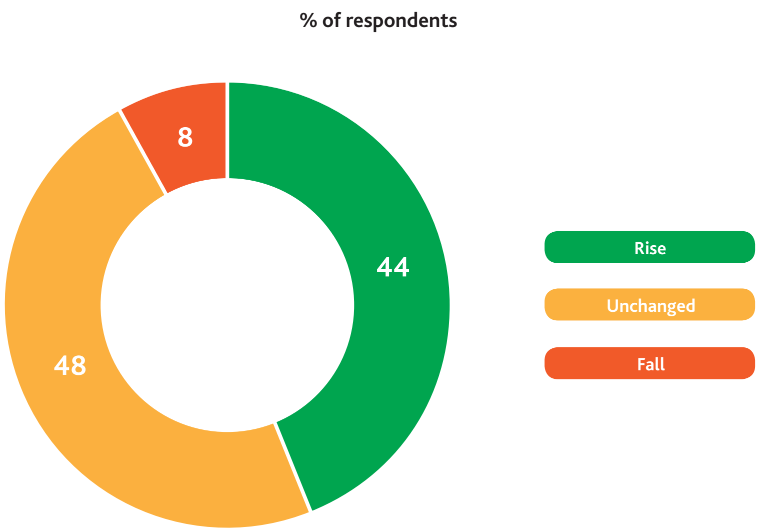
Longer periods can also allow compounding to work on dividends and enhance total returns, while coping with violent swings in market sentiment.

In the final analysis, the revived interest in long-term investing boils down to a practical necessity: do what is most likely to work in a dynamic environment.

There are no all-weather strategies. Pragmatism is the name of the game.

Section 3 provides further details (p.19-24)

Figure 1.4 **Overall, how will any regime change in investing affect the importance of long-term investing for your pension plan compared with the recent past?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"There is no 'old' normal and 'new' normal: just another 'normal' for a different phase."

"To paraphrase Winston Churchill, buy and hold is the worst strategy, except for all the others."

Theme 5 ESG is increasingly used to discover fat-tail or far-off risks

There is widespread recognition that there is far too much 'noise' in today's financial markets. One way to ride it out is to focus on deeper and durable technological, regulatory, environmental and socio-demographic forces that are reshaping our economies and societies, and capitalise on their inherent investment opportunities.

ESG thus allows investors to look beyond blind spots that come from short-termism and help detect and manage the long-term risks that are unfamiliar to the conventional risk models. Hence, ESG factors are integrated into both top-down country allocation and bottom-up security selection.

ESG thus allows investors to look beyond blind spots that come from short-termism.

Currently, our survey respondents are at different phases of the implementation cycle (Figure 1.5, left chart). 24% of our respondents already have a '*mature*' ESG portfolio. A further 28% are now in the '*implementation*' phase, while 19% are '*close to decision making*' and 29% are still at the '*awareness raising*' phase.

The average allocation for the whole survey sample is 36%. 61% of respondents expect the allocation to '*increase*' and 39% expect it to '*remain static*' (Figure 1.5, right chart).

When asked to describe their pension plan's role on ESG, the following were identified:

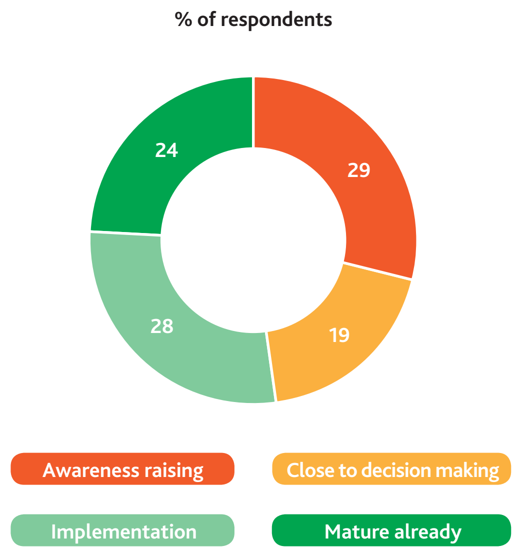
- activist: 29% said '*investors have a role to play*'
- believer: 27% said '*it works for investors*'
- pragmatist: 21% said '*let's give it a try*'
- sceptic: 12% said '*remain to be convinced*'
- visionary: 9% said '*let's create a better world*'
- nonbeliever: 2% said '*it's just a fad*'.

In the last decade, the interest in long-horizon outcomes was rare. And when it prevailed, it was severely tested by events. The long term was viewed as opaque and uncertain. It is amazing how attitudes change when new opportunities emerge. A hard-nosed approach to ESG is evident.

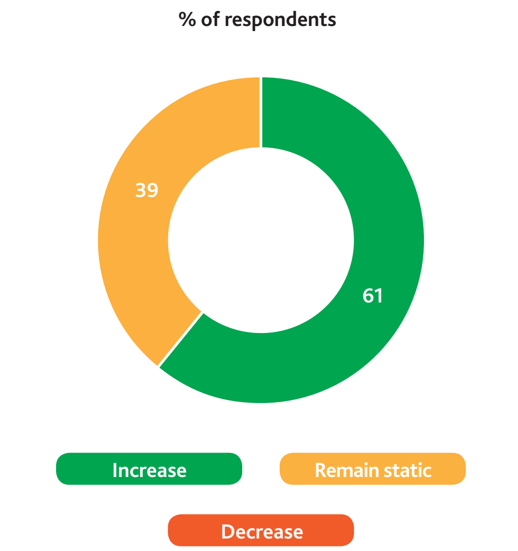
Section 4 provides further details (p.25-30)

Figure 1.5

When considering ESG investment, in which stage is your pension plan currently?



How will your ESG allocation change over the next three years?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"The number of extreme climate events causing financial losses has tripled since 1990."

"Our neglect of socio-environmental issues will shock future generations."

Theme 6 Asset managers need new capabilities for a new regime

It's all about winning by not losing.

While markets remain disconnected from their fundamentals, investing has become a loser's game: one where the winner is the one not with the best strategy, but the one who makes fewest mistakes.

It's all about winning by not losing in the face of the four prospective shifts: from globalism to populism, from monetary to fiscal policy, from deflation to inflation, and from over-regulation to deregulation. Hence, nearly half of all pension plans want their asset managers to (Figure 1.6):

- have a clear perspective on the changing macro environment (68%)
- look at markets from new angles (56%)
- offer a value-for-money fee structure (54%)
- discover new risk factors and manage them alongside the old ones (53%)
- stress-test investment strategies under different scenarios (46%).

Together, these and other items in Figure 1.6 should target three goals.

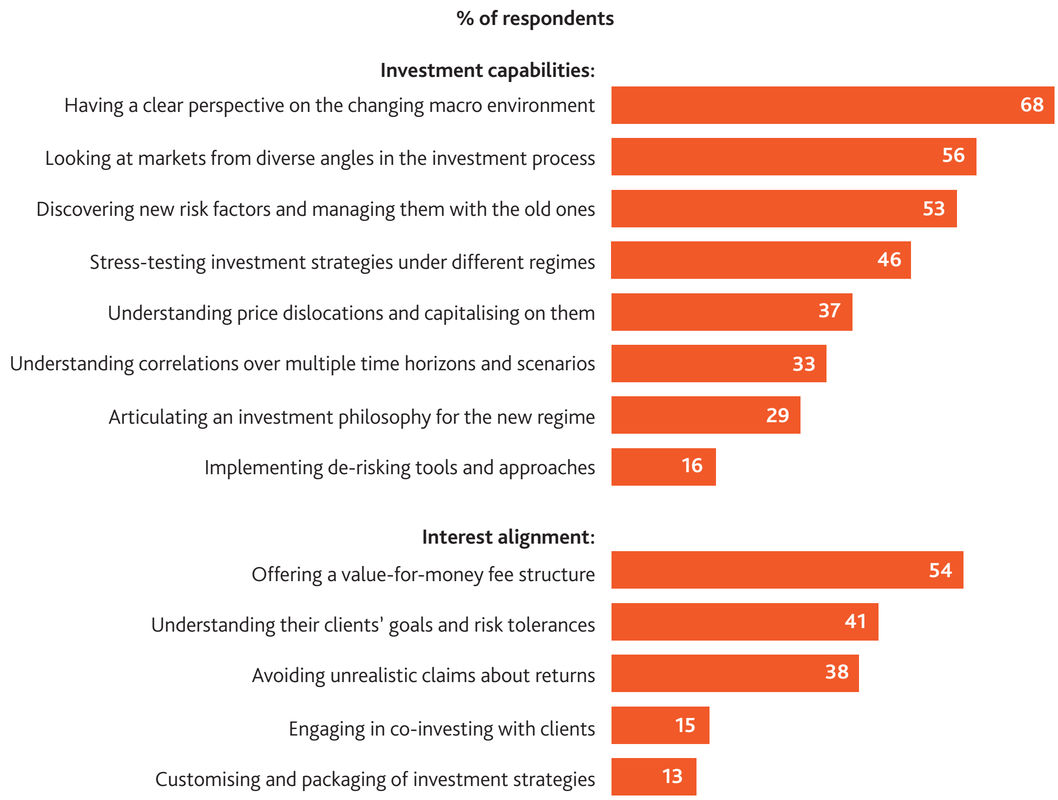
The first one is to broaden and deepen existing investment capabilities. New lenses are needed to look at markets from perspectives as diverse as politics, psychology and philosophy.

The second goal is to discover new risk factors and stress-test the portfolios over multiple scenarios and time horizons.

The third goal is to promote a better alignment of interests by: making the current fee structures more meritocratic, with a more equitable sharing of pain and gain; avoiding me-too products not tested by time or events; and offering proactive investment ideas.

Section 3 provides further details (p.19-24)

Figure 1.6 Which capabilities do asset managers need to develop, if their clients are to benefit as and when shifts materialise?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Persistent deficits have trapped trustees in a pressure cooker environment. They now expect a lot from their managers."

"If a volatility trade goes pear-shaped, it needs to hurt the asset manager."

2

Drivers of future returns:

What tools, vehicles and strategies will be deployed?

Overview

Aims

Taking a three-year forward look, this section highlights three aspects of the asset allocation of our survey respondents:

- the key drivers of market returns
- the principles guiding asset allocation
- the asset class choices.

Key findings

a. Return drivers

The key drivers will be:

- central bank policies
- global growth outlook
- rising global debt
- the election of President Trump
- creeping protectionism.

"On its entry, QE did more good than harm. On its exit, it might do more harm than good. Excess liquidity has seeped into cracks we don't know about. Nobody knows what risks are being stoked up."

An interview quote

These drivers herald the four most likely shifts in the global economy, as discussed in Section 1.

These shifts will have negative as well as positive impacts, pulling investors in different directions. Some impacts will be offset by others. Higher inflation is the only apparent outcome at this point in time.

b. Principles guiding asset allocation

Given the uncertainty of net results, pension investors feel it necessary to prepare for a world where the unexpected can happen, on the upside as well as the downside.

In this environment, the guiding principles will be:

- blend caution with opportunism
- become more savvy in the art of investing
- build portfolios resilient to fat-tail events
- capitalise on periodic market dislocations
- combine top-down asset allocation with bottom-up asset picking to generate added value.

As a result, pension investors are likely to rely much more on:

- asset allocation tools such as risk factor investing, absolute return investing and buy-and-hold investing
- investment vehicles such as multi-asset class funds, smart beta and ETFs
- investment strategies such as real assets, theme funds, alternative investments and bottom-up investing.

c. Asset class choices

Pragmatism will favour two broad sets of asset classes:

- quality equities that can deliver high total returns
- alternative investments that can provide hedges against inflation and rate rises.

In contrast, fixed income assets are likely to be least favoured, as central banks start quantitative tightening by raising interest rates.

A diverse set of market drivers will pull investors in different directions

There is a sense of cyclical recovery in the global economy. The sentiment that the crisis is over has itself served to ease it.

2017 is the first year in a decade when no advanced economy is experiencing deflation. There's a sense of cyclical recovery in the global economy. The sentiment that the crisis is over has itself served to ease it. Markets are at an all-time high, with unusually low volatility.

Ultra-accommodative monetary action by central banks has been one factor. The other is the reflationary proposals of President Trump. Evidently, markets have priced in all their good elements even before they are formalised, 'assuming the best' until proven otherwise.

Against that background, at least one in every two survey respondents has identified five related factors that are likely to drive financial markets over the next three years (Figure 2.1). The first three are familiar; the last two are new.

Taking them in turn, the key one is monetary action by central banks (cited by 59%). So far, it has artificially boosted valuations in all asset classes, while keeping a floor under them. Now, it has reached the point of diminishing returns and faces a gradual reversal.

The US Federal Reserve has already embarked on policy normalisation with clear targets for rate rises and balance sheet shrinkage. The Bank of England has followed suit and the European Central Bank is likely to do so in 2018 in the belief that inflation is set to rise. But our survey respondents see this as a mixed blessing.

On the plus side, it means markets and interest rates can move away from the artificial levels that have severely distorted capital allocation and asset prices.

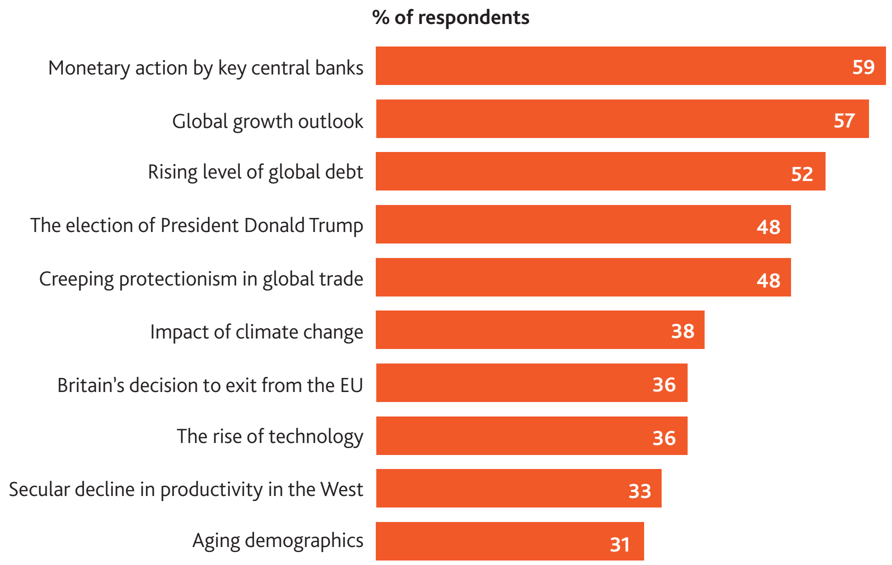
On the minus side, however, there are fears that the expansion in the global economy has some way to go to generate the necessary earnings growth that would justify the current over-stretched earnings multiples.

Premature rate rises may turn what is now a stabilising force into a potentially destabilising force, causing severe market and economic dislocation.

Possibly, an unspoken catalyst for policy normalisation in the US is the Fed's desire for more room for manoeuvre in the next recession.

The second familiar driver will be global growth outlook (57%). The modest recovery this year has boosted earnings and supported asset valuations. But its sustainability is in doubt. Few governments have taken steps to improve the '*supply side*' of their economies,

Figure 2.1 **Which factors will drive financial markets over the next 3 years?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"The Fed is a test case of whether central banks can normalise without causing turbulence."

"Excess liquidity has boosted asset values. Its withdrawal has to be a long slow burn issue."

For pension investors, the near term is no more than a journey of twists and turns. The past is no longer a good guide to the future.

while relying on massive monetary stimulus to do the heavy lifting. Additionally, the spectre of a major conflict on the Korean peninsula could easily derail current progress.

The third familiar driver is rising global debt (52%), limiting the scope and timing of the rate hike cycles. Since 2008, debt has risen by a further US$60 trillion, pushing the global debt/GDP ratio to its all-time high at 325% in 2016.

The very toxin that created the 2008-09 crisis is being relied upon to reboot the key economies. Worryingly, we shall enter the next recession – when it comes – with record government, corporate and consumer debt as well as plan deficits. Debt crises rarely have a happy ending.

Then there are two other related drivers that have only emerged more recently, giving rise to wholly unfamiliar political risks not experienced in living memory. The first of these is the election of President Trump (cited by 48%). His views on infrastructure spending, tax reforms and deregulation could potentially boost growth and inflation in the US, with spill-over effects for the global economy via trade and financial linkages.

However, his damaging views on tariffs, trade and immigration may well lead to a cycle of retaliation by America's key trading partners; China and Mexico, especially, have been singled out by President Trump for unfair trade and/or currency practices. His plans could harm political stability and long-standing trade and defence arrangements, thereby increasing the risk of a fat-tail event.

Related to this is creeping protectionism in global trade (cited by 48%). With the rise of populism, globalisation appears to have peaked, with major ramifications, especially for trade-oriented economies in the developing world.

Hence, for investors, the near term is a journey of twists and turns. The past is no longer a good guide to the future. All they know is that they are transitioning from a long period of asset reflation to a more mature phase of the market cycle, with the US well ahead of the pack, followed by Europe.

They also sense that they are in the midst of four shifts that may reshape the investment landscape (see Insights below).

Interview quotes

"Populism is more likely to stoke up inflation than boost growth, if the experience of the Latin American countries is any guide."

"In today's environment, there is a decreased likelihood of small loss events but an increased likelihood of a major loss event."

Insights

Investors have to brace themselves with market moving events

"Markets seem to assume the best about the future policies of central banks in general and Mr Trump in particular. But the future remains shrouded in mystery. Investors hoping for muted volatility may be disappointed.

We don't know whether President Trump will be able to pursue his fiscal agenda. Currently, there is no appetite for spiralling budget deficits in Congress. A reality check is under way and the risk of disappointment has increased in recent months. In that event, he will likely turn ever more hawkish on trade and currency matters where he does not need Congressional approval.

The rise of populism is for real, however. It marks an inflection point for globalisation, which has lifted millions of people out of poverty in the emerging economies. But it has also reduced prices and median wages in developed countries, causing job insecurity, political alienation and social dysfunction.

Governments were caught on the back foot. Few had policies to help individuals and localities to adjust to rapid socio-economic changes.

Now, a number of actions are in progress. They may well bring about shifts from globalism to protectionism, from monetary to fiscal policy, from deflation to inflation, and from over-regulation to deregulation.

For, investors, the outcomes range between extremes: booming markets where fundamentals drive asset prices again at one end; and turmoil with periodic volatility spikes at the other, with no precedents to guide us."

~ A Finnish Pension Plan

Pension investors will use an eclectic approach to asset allocation

Pension plans have to judge how much longer the current sweet spot for risky assets will last in the face of overcrowded and convictionless trades.

The speed and impact of the macro shifts just discussed are a matter of conjecture. Different shifts will be pulling asset classes in different directions, as we shall soon see. In the meantime, pension plans have to judge how much longer the current sweet spot for risky assets will last in the face of overcrowded and convictionless trades.

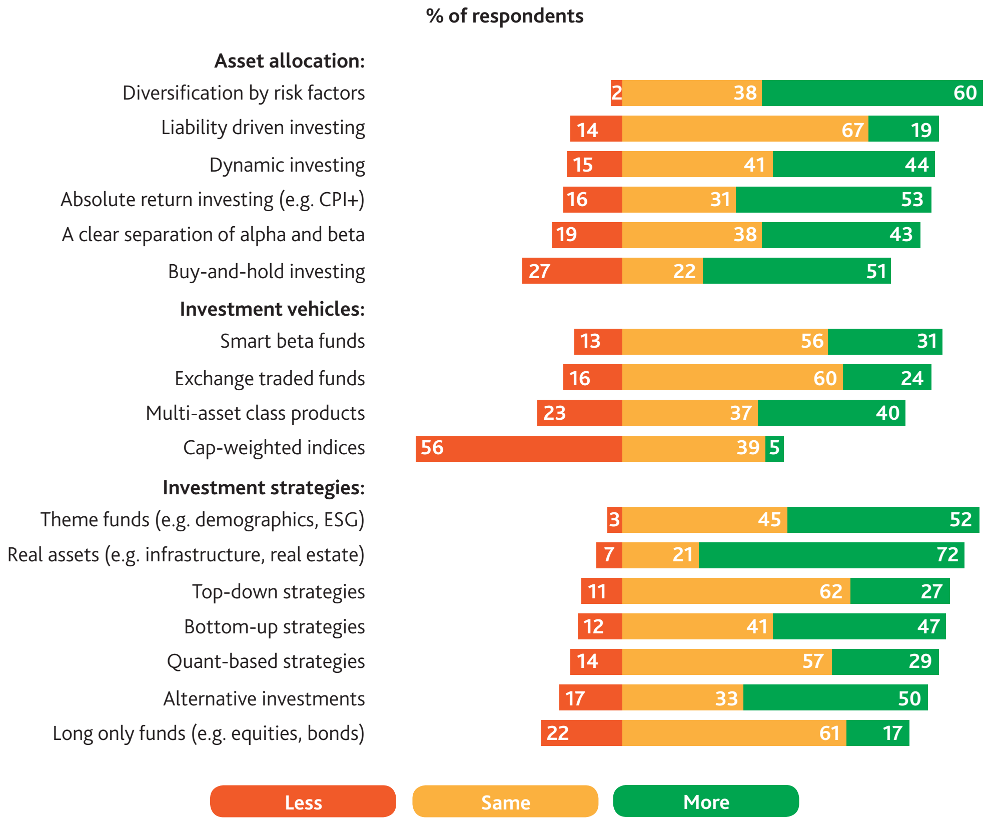
Against that uncertain backdrop, pension plans will continue to look for sources of capital conservation, high income and capital growth as their liabilities mature due to aging demographics (see Figure 1.2; p.6).

In the process, their investment approaches will have three aims: resilience against high-impact/low-probability events; opportunism that seeks to capitalise on periodic market dislocation; and bottom-up asset picking that targets under-valued and under-researched assets. This eclectic mix will enhance the roles of various tools and techniques in three generic areas that underpin their investment portfolios (Figure 2.2).

In asset allocation, the enhanced role will aim to:

- minimise the correlations between traditional asset classes via diversification by risk factors that aim to reduce risk rather than maximise returns
- benchmark the returns against plan liabilities via absolute return investing
- extend time horizons while risk premia remain volatile and unpredictable
- 'buy the dips and sell the peaks' via dynamic investing that capitalises on periodic opportunities as and when they arise
- minimise costs via a clear separation of alpha and beta.

Figure 2.2 **In light of the identified market drivers, how will the importance of various aspects of your pension plan's investment approach change over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"The main challenge is to cope with a market we don't trust, while acting as if we do."

"The trick is to stay on the dance floor but fairly close to the exit."

Pension plans are forced to do a balancing act, while 'wrong time' risk and 'regret' risk are both lurking in the background.

In the area of investment vehicles, the enhanced role will aim to:

- achieve cost-effective diversification via multi-asset class products where fees are charged on net performance
- gain factor-specific exposure to gain alpha at beta risk via smart beta
- to pursue specific investment themes at lower cost via ETFs.

Notably, cap-weighted indices are likely to receive less emphasis for two reasons: their strong price momentum makes them vulnerable in the down market; and smart beta and ETFs are seen as more effective substitutes.

Finally, in the area of investment strategies, the enhanced role will aim to:

- target income, regular cash flow, inflation protection and capital growth via real assets
- pursue long-term trends like climate change and demographics via theme funds
- seek uncorrelated absolute returns via alternative asset classes
- target selective opportunities in various asset classes and regions via bottom-up strategies.

The rising importance of some of these tools, vehicles and strategies more than others reveals the balancing act that pension plans are forced to do, while 'wrong time' risk and 'regret' risk are both lurking in the background.

On the one hand is the need to recognise that future returns for most asset classes will be lower than in the recent past because QE has brought them forward; on the other hand is the need to avoid the regret of missing periodic opportunities as markets transition to a different regime.

Interview quotes

"To be risk averse is the biggest risk. To do nothing in the face of wild variables is not an option when your plan is in deficit."

"Finding good investible proxies for various risk factors can be hard but quite rewarding, if you can."

Insights

Factor-based diversification will remain on the rise

The case for diversification remains as strong as ever, despite the fact that the conventional diversification based on asset classes came unhinged in the 2008 crisis. The question is what to diversify.

We discovered to our cost that, for example, US equities and corporate bonds share common exposures to currency, volatility and inflation risk. These helped to explain the high correlation between these two seemingly uncorrelated asset classes. The crisis also showed that asset class correlations are asymmetric: low in the rising market and high in the falling market.

We have since moved towards factor investing in our equity portfolio, targeting low variance and quality factors. The results have been good enough to encourage us to move towards a multi-factor approach. Individual factors have their own cycles of performance. So, diversifying across a wide range of them can deliver smooth risk-adjusted returns in time.

These advantages however do not detract from three challenges associated with factor investing in practice.

First, there are no simple rules of thumb that link factors and their returns. For example, evidence of a link between GDP (an important macro factor) and equity returns is somewhat tenuous.

The second challenge arises when we construct a multi-factor approach based on different macro economic scenarios. The scope for error rises rapidly, as the number of underlying assumptions that have to be made increases.

The final challenge arises when we search for new factors related to the emerging political risks. Our asset managers will need to make judgement calls on which factors to select, which data to apply, and when to unweight, down weight, redefine or switch off a factor. After all, factors can become over-valued as they attract new money. The arrival of 'Big Data' will help.

Our initial approach to factor investing in the equity space has delivered good results. We are now migrating part of our bond portfolio by adopting fundamental indices.

The use of the underlying systematic strategies is not only cost effective but also gives us a dashboard of all the risks we are taking and the required mitigation strategies.

~ A Swedish Plan

Pragmatism will promote the rise of equities

After the first ten turbulent months, it is hard to know whether the Trump presidency will be a source of stability or instability.

Two factors will drive the asset choices of pension investors: the likely effects of macro shifts discussed previously and the dynamics of the current market cycle, as it transitions from a long period of asset growth to a more mature phase exposed to these macro changes. Three themes will characterise asset choices.

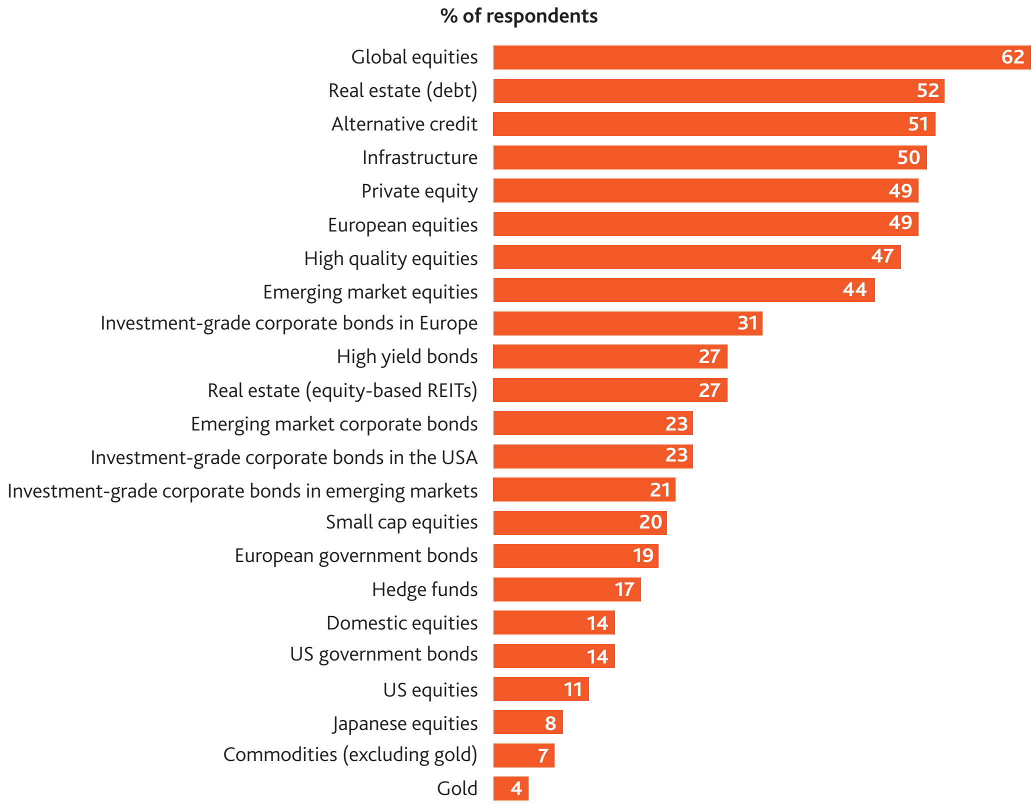
The first theme is the continuing pull of quality equities that gain more by losing less, outperforming the market over a full cycle. In the prevailing environment of the next three years, they are expected to do much better than bonds in a balanced portfolio held over a longer period of time.

Asset classes once considered too risky can acquire 'safe haven' status when the market environment changes. Of the top ten asset classes that are likely to be favoured over the next three years, four are equity-related. Global equities will be topping the list (Figure 2.3):

EM equities will continue to retain their hallmark – high average volatility – due to their greater exposure to geopolitical and protectionism risks. Yet, they will still be favoured because of solid recovery and a strong demographic dividend fuelling consumer demand. With the high dispersion of returns, selectivity by country and company will be essential. Not all EMs are created equal. There is more that divides them than unites them.

The top ten list includes European and EM equities but not US equities. The latter have fully priced in all the positive news since the election of President Trump, but there are other risk factors that are not yet priced in: his policies on taxes and protectionism and his hawkish stance on North Korea. After the first ten turbulent months, it's hard to know whether the Trump presidency will be a source of stability or instability.

Figure 2.3 **Which asset classes will be most suited to meet your plan's goals over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Every cycle ends with an inverted yield curve. It's gone flat in the US. But it might be distorted by central bank action. "

"The easiest way to hedge risk is to invest in high-quality assets and have low turnover."

Pension investors will stick to the strategy of reducing duration and credit risk – in the belief that the Fed will hike rates, as promised.

Japanese equities are approaching peaks. They are trading at a discount to their US peers by as much as 20%. The artificial boost from large-scale purchases by the Bank of Japan have lowered their appeal, however.

The second theme influencing asset choices is the continuing rise of alternatives. Nearly 50% of our respondents have singled out real estate, alternative credit, private equity and infrastructure.

Real estate will go on attracting rising allocations after scoring new highs lately. Like infrastructure, it is now credited with defensive features such as steady capital growth, regular income and inflation protection.

The search for yield will continue to penetrate the alternative credit landscape – covering direct lending, senior loans, mezzanine finance and floating rate notes. It will remain popular amongst pension plans who want to exploit the illiquidity premium, despite their expected lower returns.

The third and the final theme influencing asset choices is the concern that the 35-year bull market in bonds is ending. Less than a third of our respondents will increase their allocation to fixed income.

In the US, the credit cycle is aging and advancing into a mature stage. Corporate debt has increased to facilitate buybacks. In 2008, IG and HY bonds in addition to leverage loans totalled US$3.5 trillion. Now it is US$8.1 trillion. Both these asset classes are overvalued. An increase in real rates could jack up default rates. European corporates have not experienced the same increase in leverage.

But pension investors will stick to the strategy of reducing duration and credit risk – in the belief that the Fed will hike rates in the current cycle, as will the Bank of England, and the ECB will follow suit in 2018.

Interview quotes

"When it comes to populism, inflation rather than growth will be the main outcome."

"Recent downgrades of China's debt by the top two rating agencies were treated as a non-event."

Insights

This could be the age of the stock pickers

In itself, the US rate rises are not bad for equities because the Fed usually tightens when the economy overheats. This also means that earnings are growing robustly. Both rates and earnings play a role in setting equity values.

A company's market value reflects the present value of its future earnings stream. As rates rise, present value drops. However, if earnings are rising enough to compensate for that, rising equity valuation can exist alongside rising rates. It's when earnings growth is too low – or negative – that the Fed's rate rises can have an outsized negative impact on valuation.

The pick-up in global growth since mid-2016 has boosted earnings in all the key regions. So long as that continues, rate rises won't be a problem. We also believe that current equity valuations are OK because the total return they provide is worth more than bonds. Comparing valuation metrics to past levels may be a poor guide to the future due to price distortion caused by central bank action. You have to see equities with new eyes.

The main risk to equities comes from President Trump's two proposals. The first one is an aggressive fiscal policy that could overheat the US economy and force the Fed to fast forward its rate hike plan to forestall inflationary pressures. Aggressive rate hikes have been the root cause of US recessions in the past.

Another proposal relates to protectionism and the risk of retaliation by other nations. Via strong global supply chains, the end game could be lower trade, lower growth and higher costs in the US. Protectionism could unleash an era of cost push inflation in other countries too. The net effect of the Trump agenda might well simply be higher inflation. Inflationary pressures remain subdued outside the US. But anything is possible.

Current reading of the US yield curve does not offer much comfort. It has flattened now, with short-term rates rising due to Fed action while longer-term rates have tumbled due to investor worries.

This casts doubt on whether the Fed will be able to normalise. Every US business cycle has ended with an inverted yield curve. Maybe in the age of QE, past relationships no longer hold. But no one knows.

~ A Danish Plan

3

The rise of long-term investing:

Necessity or choice?

Overview

Aims

This section focuses on the future of long-term investing. It aims to:

- highlight the changing importance of the traditional principles of investing, as pension plans face major shifts in the global economy
- examine reasons that will drive the rise of long-term investing, as volatility rises and markets enter a low-return environment.

Key findings

a. The changing importance of traditional principles

"There are no all-weather strategies. So, pragmatism is the name of the game."

An interview quote

The key findings are:

- the emerging shifts are leading to a reappraisal of the principles that have long guided pension plans historically
- at least one in every two survey respondents now pays more attention to the following principles: diversification is essential, market timing is futile, value investing works, risk generates returns, buy-and-hold investing works, and markets revert to their mean
- high volatility will be the norm and few pension plans have the skills and nimbleness to capitalise on it
- asset class return will remain volatile and unpredictable. Hence investors have to increase their holding periods to allow more time for risk premia to materialise.

b. Rise of long-term investing

The key findings are:

- historically, pension plans have relied on equity risk premium to guide their asset choices
- now they can no longer do so, since the notion of a 'risk-free rate' no longer holds while rates are artificially suppressed
- as the search for relative value has intensified, the widespread 'buy the dip' mentality has prevented markets from having healthy corrections from time to time, storing up even bigger corrections in future
- as a result, pension plans are blending caution, opportunity and patience
- long-term investing has gained relevance, as has the desire to have a lower portfolio turnover
- the aim is to allow more time for risk premia to materialise, while taking advantage of short-term opportunities as and when they arise.

Resisting over-reaction to the 24-hour news cycle

High volatility will be the norm. Timing the markets is a fool's errand.

In today's digital age, investors can easily get too pre-occupied with the here and now while losing wider perspective.

However, our survey shows that pension investors do realise this danger. They also recognise that the new situation demands a reappraisal of the principles that have guided long-term investors in the past.

This reappraisal has elevated the importance of some of these investment principles, leaving others unchanged (Figure 3.1). At least 40% of respondents have elevated the role of the following principles:

- market timing is difficult (cited by 81% of respondents)
- diversification is essential (77%)
- risk generates returns (77%)
- buy-and-hold investing works (50%)
- markets revert to their mean (49%)
- asset valuations revert to their mean (47%)
- value investing works (44%)
- following the herd is inadvisable (41%).

These principles are inter-related. They convey four messages about markets as they transition to a new phase.

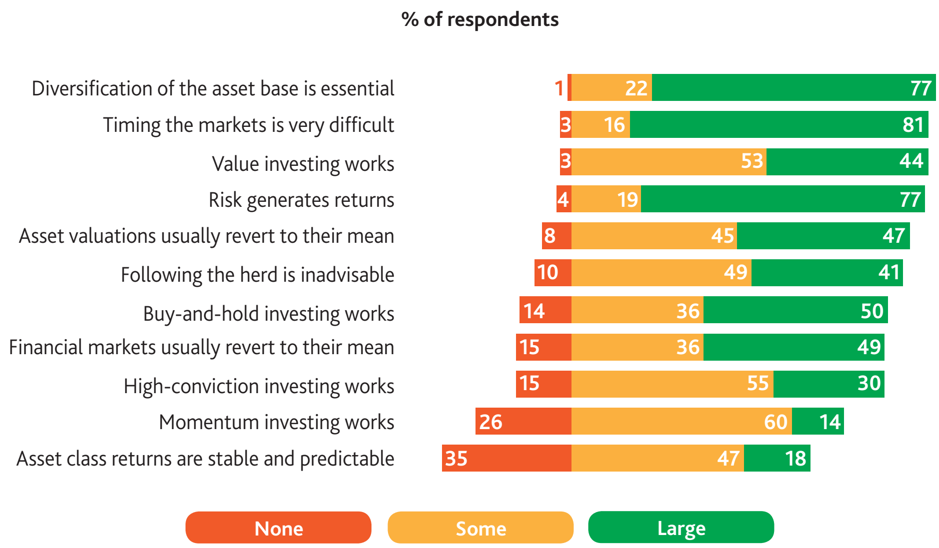
First, high volatility will be the norm. Timing the market is a fool's errand. Few pension plans have the skills and nimbleness to engage in it. Depending upon how the political risks pan out, markets could get as volatile as they did during 2011-13, when the Eurozone crisis roiled them for extended periods and left them directionless.

Second, diversification will remain essential. The key will be to identify new risks and hedge them via a broad palette of assets. Pension plans are in the cross hairs. Aging member demographics call for rapid de-risking. But that is not viable while the majority of pension plans have funding deficits.

The key difference from the past will be a shift from asset classes to risk factors, as ever more pension plans resort to risk factor investing (as seen in Figure 2.2; p.15).

The way diversification – based on asset classes – has been implemented over the last thirty years has rarely been consistent with the

Figure 3.1 **To what extent do the traditional principles of investing influence your pension plan's investment decisions?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"We have to invest in the markets as they are, not as we wish them to be."

"Mean reversion is alive and well. It just takes longer to come though."

The argument in favour of longer holding periods is also supported by the belief that mean reversion is not dead.

objective of adding value because of the rising asset class correlations. Good returns were often more a matter of luck than judgement.

Third, asset class returns will remain volatile and unpredictable. Hence investors have to increase their holding periods to allow risk premia to materialise.

This argument in favour of longer holding periods is also supported by the belief that mean reversion is not dead. It will continue to apply to both markets as well as asset classes.

The latest MiFiD regime will lend fresh impetus to long-term investing via total transparency around fees and charges.

Interestingly, high conviction investing is unlikely to command more attention from only 30%. That is because asset class returns will remain volatile. Additionally, the rise of systemic strategies like smart beta and ETFs will attract fresh assets from active investing.

Finally, our overall results imply a changing emphasis on different principles rather than on radical departures, as implied by the '*some extent*' scores in Figure 3.1. Even momentum investing, long frowned upon, will be favoured to some extent by 60% – when it is working.

While putting more emphasis on certain principles, pension plans have not shut the door on others. It's all a matter of what works in a dynamic environment.

There are no all-weather strategies.

Interview quotes

"In investing, it's a matter of 'horses for courses': it's about choosing what will work in different cycles."

"Asset prices go up in steps but come down in escalators. The sequence of returns matters. So, you can't ignore short-term losses."

Insights

Essential to revisit your investment beliefs in different phases

John Maynard Keynes once said that 'when facts change, I change my views. What do you do?'

Experience over the past 20 years has forced us to do just that.

Two bear markets in the short span of eight years over the last decade has sidelined investment wisdom. Asset class diversification failed when it was needed most. The gap between actual and expected returns got wider over time, due to risk-on/risk-off cycles.

As if that were not enough, in this decade, central bank action has created artificial markets. With a single large buyer, bond markets have practically ceased to function. But as pension investors, we have to remain invested. We have to accept the markets as they are.

The 2008 collapse devastated our portfolio. Since then, we have been trying to come up with a total strategy that can deliver decent returns over a longer period, while offering protection against wild rides from time to time. We have learnt a number of lessons, which now influence our asset choices.

It is one thing talking about alpha, but quite another delivering it: it can be ephemeral and expensive.

The past may be a good guide to the future, but it's a very imperfect one: the relationship between risk and return is volatile and unpredictable.

Diversification can be highly elusive: its advantages disappear when we need them most – during a crisis.

Long-term investing makes sense when you have long-term contractual liabilities: but ignore the short term at your peril.

Costs matter: via their compounding effect over time, they can be a key source of out-performance.

The world of investment is best considered in terms of 10-20 year cycles. There is no 'old' normal and 'new' normal: just different normals for different phases. It's time to ditch the nostalgia about the 'old' normal that never was.

In this current phase, our investing is based on four core beliefs: diversification still works if based on risk factors, not asset classes; risk generates returns, if you're a buy-and-hold investor; markets revert to their mean; and a certain degree of opportunism is essential.

~ A Norwegian pension plan

'Time in' the market matters more than 'timing' the market

As markets have run ahead of themselves, long-term investing has gained relevance.

Historically, pension plans have relied on the time-honoured *equity risk premium* as a weathervane for investors' hopes and fears. Now, they can no longer do so, since the notion of '*risk-free rate*' implicit in ERP no longer holds, while interest rates are so low and bonds lack sensible anchor points at all maturities.

Their task is now more difficult with the rise of the widespread 'buy the dip' mentality whenever markets head south. It prevents healthy small corrections periodically, while creating the right conditions for a big correction at a later stage.

Pension plans are thus forced to perform a balancing act. While it is unwise to ignore the possibility of a big drawdown, it is also unwise to ignore the improving fundamentals of the global economy. Anything is possible.

Pension plans, therefore, have to factor in these seeming opposites in their investment approaches by blending caution, opportunity and patience in the belief that risk premia are likely to materialise over a longer period.

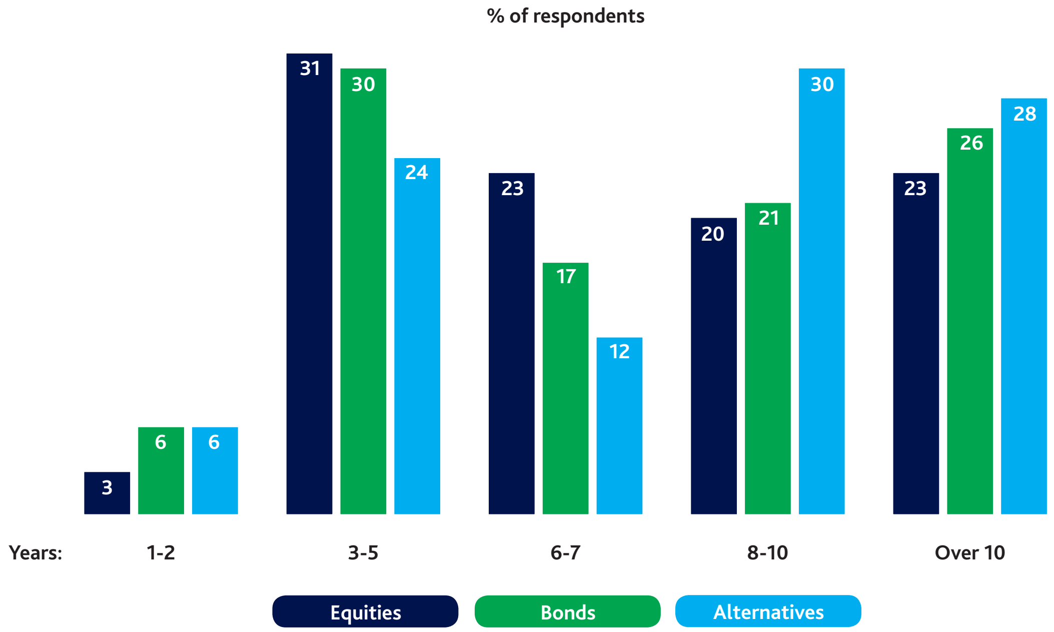
Hence, as markets have run ahead of themselves, long-term investing has gained relevance. Besides, investing in equities is an imprecise science over a period of a year or less due to regular irrational swings in market sentiment.

Currently, for operational purposes, there are mild differences between three broad asset classes (Figure 3.2).

With equities, only 3% of respondents have a holding period of two years or less; 34% have a holding period of five years or less; and 66% have a holding period of six years or more. The shorter periods apply to cyclical and tactical strategies and the longer periods to value strategies.

With bonds, the picture is similar: 6% have a holding period of two years or less; 36% have a period of five years or less; and 64% have a period of six years or more. The short duration bonds have smaller periods and the long-term ones have longer periods.

Figure 3.2 **For operational purposes, which of the following time periods currently defines your pension plan's interpretation of 'long-term investing'?**



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"We can't afford to take risks with our deficit so big. Nor can we cut the deficit without taking risks. It's a Catch-22."

"There are no risk-free assets except cash. So you have to make the most of whatever works in the surreal world of near-zero rates."

The implied support for buy-and-hold investing does not necessarily mean hanging on to a position come what may.

With alternatives, 6% have a holding period of two years or less; 30% have a holding period of five years or less; and 70% have a holding period of six years or more. Trading-oriented strategies such as hedge funds and long-short funds have shorter periods; while illiquid strategies like real estate, private equity and infrastructure have longer ones.

When asked whether lower portfolio turnover delivers better returns, our survey respondents replied as follows:

- equities: '*yes*' 60%; '*no*' 16%
- bonds: '*yes*' 50%; '*no*' 22%
- alternatives: '*yes*' 46%; '*no*' 24%.

Lower transaction costs are one factor behind these preferences. They average 45 basis points for an average pension plan. Another factor is uncertainty resulting from various shifts described in Section 2. They will most likely oblige pension plans to increase their holding periods (see Figure 1.4; p.8), if risk premia take longer to materialise.

The implied support for buy-and-hold investing does not necessarily mean hanging on to a position come what may. Instead, for equities, it means evaluating the long-term viability of a company on specific criteria and holding a position so long as these are discounted in the current stock price. If the actual price is higher than the discounted price, the stock may be sold and only repurchased when the situation is reversed.

Such pragmatism also holds that asset class diversification is not the only way to avoid losses on equity investments during market stress.

Longer equity holding periods too can allow these losses to be offset against subsequent gains as markets recover – so long as there is an exit strategy already in place to cope with big corrections. Longer holding periods can also allow compounding to work on dividends and enhance total returns.

Interview quotes

"In a bear market, risk minimisation is the dominant instinct. In a bull market, it is regret minimisation."

"Stocks of high-dividend companies gain more by losing less. They tend to outperform the market over a full cycle."

Insights

Long-term investing is a matter of necessity as much as choice

By definition, we are a long-term investor because our pension liabilities stretch over a 50-year period. So, we should take a long-term view on asset allocation.

However, our pension plan is in negative cash flow territory: more money goes out than comes in due to aging membership. We also have a funding deficit, which means that our capital base is shrinking, just when we need to grow it.

Our sponsor covenant is not so strong, after fresh one-off cash injections on top of an increase in contributions from 17% in 2006 to 22% currently. The sponsor sees employee pensions as a legacy commitment, not a device to motivate employees, as originally envisaged. It sees little upside.

Hence, decent and consistent return is our top priority, while conserving our capital. We remain anxious that the normalisation of policy by the US Federal Reserve could rock the markets if the Fed gets the timing wrong.

In addition, the Trump agenda is exposed to policy errors that could hit the global economy. But markets are powering ahead while remaining fragile under the surface.

We constantly question how sustainable the current valuations are. At the same time, there are no obvious immediate threats that could cause a correction. In fact, we have been expecting one since 2014 and it hasn't happened.

Fears of bear markets remain subdued – for now. In the past, market routs occurred when rates were pushed up overzealously, or when economic growth and corporate profits were pushed into bubble territory.

Nobody knows what will happen when rates normalise on both sides of the Atlantic. Before then, we do not want to miss out on what is turning into the longest bull market ever.

The best we can do is to remain invested and take a longer-term view. It's a matter of making a virtue of necessity.

~ A German pension plan

4

ESG investing:
Reaching a tipping point?

Overview

Aims

Taking a longer-term view, this section highlights how our survey respondents see ESG:

- transitioning from niche to mainstream
- creating a new narrative for long-term investing.

Key findings

a. Transitioning to mainstream

The 2015 COP21 Paris climate conference was a game changer.

Ever more pension investors are now pricing climate risk into their portfolios.

The key reasons are to:

- manage reputational risk, as ubiquitous social media is quick to turn the spotlight on apparent abuses
- earn long-term competitive risk-adjusted returns
- manage the most severe long-term risks that modern societies face, which existing statistical models cannot capture
- achieve a broad diversification that dampens volatility
- deliver positive impacts in the wider society.

"There is a clear trend towards using positive as well as negative screens to include or exclude companies on ESG criteria."

An interview quote

b. Creating a new narrative on long-term investing

To meet their long-term contractual liabilities, pension investors need stable and prospering economies and societies.

On their part, companies need a moral as well as an economic purpose.

The two are inseparable in advanced societies, where neo-liberal policies have, as an unintended consequence, created deep divisions that lie at the root of today's rise of populism.

Pension plans are becoming acutely aware of the underlying financial risks in this environment, where their liabilities are maturing exponentially.

Their rising ESG investments are as much in deference to enlightened self-interest as to their social responsibilities.

Positive results have been most evident with respect to governance practices in emerging markets.

ESG investing is gaining momentum

Impact investing – the practice of using environmental, social and governance factors to deliver competitive financial returns as well as positive societal outcomes – is on the rise due to various durable trends.

They include: the long-term shift to a low-carbon economy, rapid technological changes, rising popular concerns about climate change, the adoption of the United Nations' *Principles for Responsible Investment* and growing investor focus on new long-term risks that can't be statistically modelled.

Following the COP21 climate conference, ever more investors are pricing in climate risk.

ESG investing aims to meet the needs of the present without compromising the ability of future generations to meet their own needs. Among the array of ESG issues, climate change now tops the list.

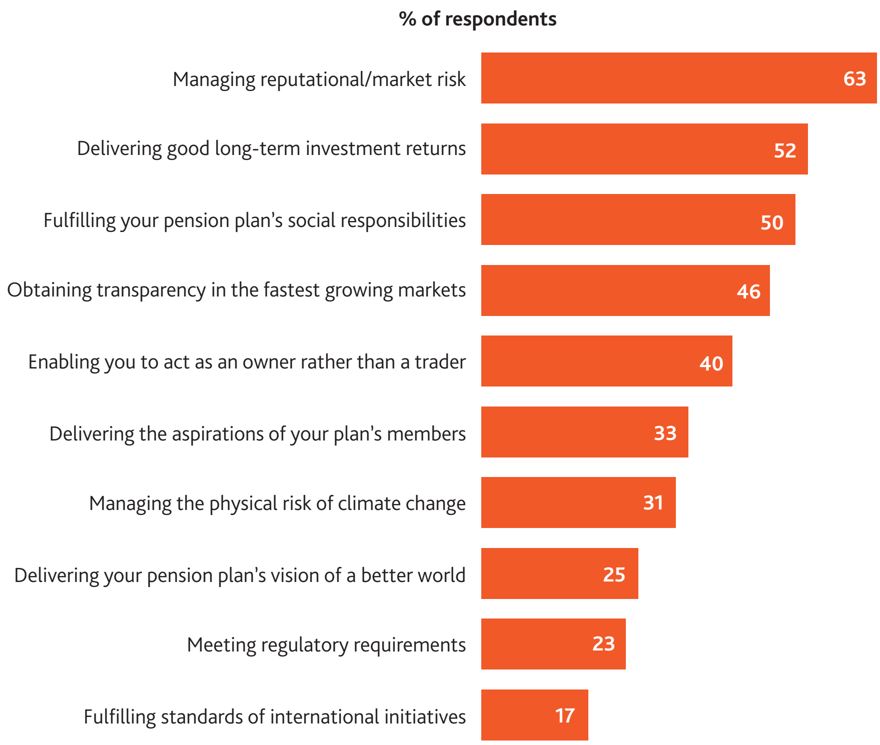
Following the COP21 Paris climate conference, ever more investors are pricing in climate risk in their traditional investing, sustainable investing and stewardship functions.

As we saw in Section 1 (Figure 1.5; p.9), 52% of our respondents are adopting ESG criteria, with an average asset allocation of 36%, which is set to rise over the next three years. When asked to cite the drivers of ESG investing, at least one in every three respondents cited the following six (Figure 4.1):

- managing reputational risk (63%)
- delivering good long-term returns (52%)
- exercising social responsibility (50%)
- facilitating investing in fast-growing emerging markets (46%)
- acting as an owner rather than a trader (40%)
- delivering the aspirations of your members (33%).

These drivers target four goals: manage reputational risk; earn competitive returns; do a broad diversification while dampening volatility;

Figure 4.1 What are your drivers when considering ESG investing?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Companies' credit spreads are highly correlated with their ESG credentials. "

"In 2016, global green bond issuance hit a record high for the fourth year running."

Physical risk, not regulatory risk, is what companies now worry about most. It can pose existential threats.

and deliver positive ESG impacts in the wider society. Other considerations are at work too.

The most important one is growing public scrutiny, with increasing expectations of transparency and disclosure, driven by ubiquitous social media. Via a raft of global initiatives, pension plans are enjoined to exercise a special '*duty of care*' in the whole sphere of impact investing, and report on it regularly.

The media has been quick to turn the spotlight on abuses that tarnish the reputation of the companies concerned as much as their shareholders'.

The latter are often painted as mere financial bandits with no regard for their social responsibilities, as happened with two high-profile corporate disasters in the US in this decade: BP's *Deep Horizon* oil spill in the Gulf of Mexico and Volkswagen's emissions-cheating scandal.

Physical risk, not regulatory risk, is what companies now worry about. It can pose existential threats.

Furthermore, ESG exposures are seen as critical in conveying information about future risks that remain unfamiliar to conventional risk models. As societies have evolved and progressed, new forms of risk have emerged. ESG is seen as focusing on the latest and most severe ones that modern societies face.

Finally, 85% of millennials are reportedly interested in, or are actively doing, ESG. In ten years, they will be the largest employee group in the pension landscape. What matters to them is not a return for today or tomorrow, but a return over their lifetime.

In 2016, $22.9 trillion was invested in ESG globally – just over a quarter of total global assets. This number is expected to increase by 10% CAGR over the rest of this decade.

Interview quotes

"Expectations for ESG are the same as for other investments. Financials and sustainability are on an equal footing."

"We believe that a long-term premium exists and ESG is a key way to harvest it. Patience and persistence are essential."

Insights

Performance potential is the key motivator for ESG investing

The Euro crisis at the start of this decade taught us that we had to find long-term drivers of value that override the regular volatility spikes. We did a detailed analysis that showed that our bond and equity investments with higher ESG ratings had better risk-adjusted returns than our conventional long-only portfolios.

We invested in skills and technology to take us further down that path. Today, around 55% of our assets are based on ESG criteria that are fully integrated into our portfolio construction, security selection and risk modelling. Our returns so far have met our expectations, while delivering positive ESG impacts.

Inevitably, high volatility at the start of this decade has forced asset owners in general to take a short-term view of the markets. Maturing liabilities due to aging memberships meant they could not afford to have big losses that required long recovery periods.

However, there has been a dawning recognition that there is far too much 'noise' in today's financial markets.

The only way to ride it out is to focus on deeper technological, regulatory, environmental and socio-demographic forces that are reshaping our economies and societies – and capitalise on their inherent investment opportunities.

Hence, ESG factors are integrated into both top-down country allocation and bottom-up security selection. Nearly 20% of our equity investments are now in low-carbon companies with good governance. A further 15% is allocated to two other areas.

The first one is ESG-based smart beta equity strategies that target risk factors such as value, quality and low variance. The other one is direct lending, which has taken us into new areas like renewable energy, including wind, solar and bio-energy; green transport covering low-carbon transport technology and equipment; and social housing providing affordable accommodation to low-income families.

In the last decade, our commitment to long-horizon outcomes was rare. And when it prevailed, it was severely tested by events. Long-term was viewed as opaque and uncertain.

It is amazing how attitudes change when new opportunities emerge.

~ A Swiss pension plan

The emergence of a new narrative for investing

The numbers are indicative of a tectonic shift under which pension plans are moving beyond a green 'do-gooder' reputation into long-term risk management to reflect the duration of their liabilities.

When asked whether their ESG investing has a specific angle in their allocations, 70% of our survey respondents singled out a blended approach, 23% focused on governance, 15% on environment and 12% on social (Figure 4.2).

The numbers are indicative of a tectonic shift under which pension investors are moving beyond a green '*do-gooder*' reputation into the realm of long-term risk management to reflect the duration of their pension liabilities. To honour them, they need a sustainable economy and a stable society, both of which require the holistic approach that ESG is designed to provide.

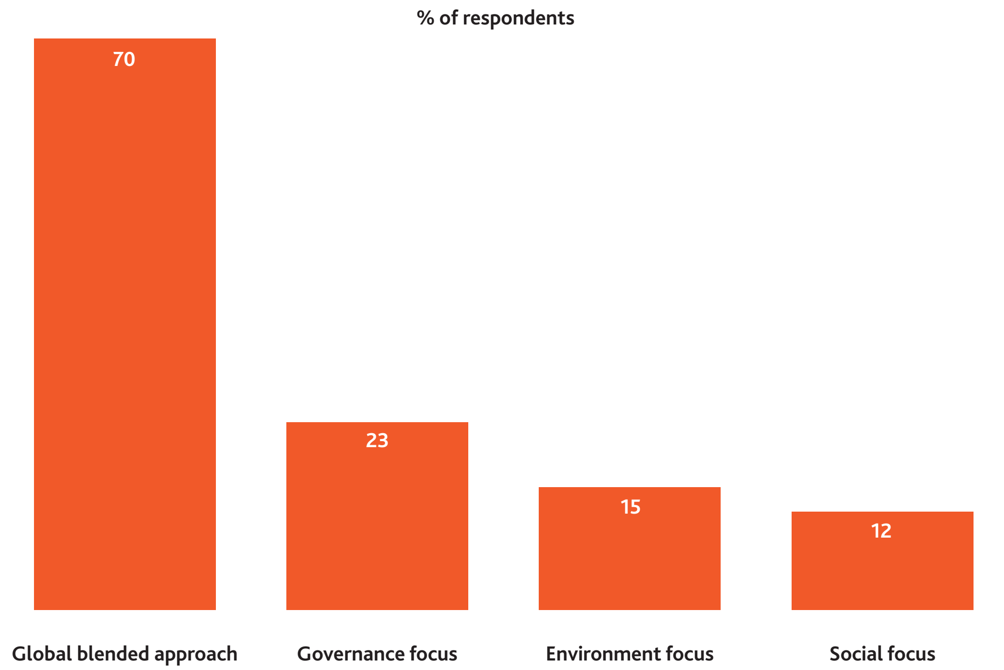
'Environment' is about how a company performs as a steward of the natural environment; 'social' is about how it manages its relationship with its customers, employees, suppliers and the wider society; and 'governance' is about shareholder rights, corporate leadership, executive pay, audits and internal controls. These are all part of the new narrative that a company has a moral as well as an economic purpose. They are inseparable.

This idea has gained currency lately with the rise of populism caused by the neo-liberalism that has been shaping the global economy for the past 40 years. Under it, a number of policy changes – over time and unwittingly – created marginalised communities, jobless workers and unsatisfied citizens.

The changes in question include: promoting inflation targeting over full employment as a principal policy goal; promoting more flexible labour markets and curtailing labour rights; increasing the transnational movement of people, capital, goods and services; and elevating shareholder value at the expense of reinvestment and growth. These changes, in turn, have undermined the long-term viability of many societies with rampant inequalities and environmental damage.

Pension plans are becoming acutely aware of the underlying financial risks, as their liabilities mature exponentially due to aging membership. The growing allocations to ESG investing are as much in deference to enlightened self-interest as to their social

Figure 4.2 Do you have a particular angle when considering ESG?



Source: Amundi Asset Management / CREATE-Research Survey 2017

Interview quotes

"Our plan has started investing in green bonds as a part of quadrupling sustainability investments by the end of this decade."

"The Dutch Pensions Federation aims to draw up an ESG covenant for pension plans, government and social organisations."

The most tangible impact has been with respect to governance risk inherent in emerging market equities and corporate bonds.

responsibility. Historically, ESG focused on private investments, but now it is widely believed that publically quoted companies also have the ability to generate significant environmental and social benefits that scale, given their huge numbers globally.

This is done in the belief that shareholders invest in companies for returns, but the legal structure of the corporate entity does not take away their moral responsibility for the actions of these businesses.

Hence, pension investors are increasingly factoring in how business operations can potentially harm people and the environment and attract heavy penalties and lawsuits from regulators that damage brand value.

In the process, they are increasingly using positive and negative screens to include or exclude companies in a portfolio on social, moral or religious grounds. This involves a more comprehensive and proactive review of a company's operations and products and their wider impacts on society.

So far, the most tangible impact relates to the governance risk inherent in emerging market equities and corporate debt. When these investments were delivering 10-15% returns annually in the 2000s, the risk was easy to price in. That is no longer possible, as their returns have almost halved.

Many EM corporates have been obliged to implement reforms that protect investor rights, diversify investor base, have independent boards, follow GAAP accounting practices, have independent audits, link executive incentives to long-term returns and have greater shareholder engagement.

Progress has been gradual but no less visible.

Interview quotes

"China alone looks poised to invest US$350 billion in renewable energy by 2020."

"Our pension commitments are long-term, so we need a sustainable economy and society."

Insights

Emerging ESG frameworks are promoting a new mindset for a carbonless future

"The decision by President Trump to withdraw the US from the Paris Treaty is unlikely to derail the momentum behind the transition to a greener future. Many major states and cities in the US will press on regardless."

We have thrown our weight behind the final recommendations of the Financial Stability Board's Task Force on climate-related financial disclosures. They enjoin companies and their investors to provide climate-related information in their annual filings, along with actions being taken to mitigate climate-related risks.

Article 173 – a provision in France's energy transition law – has gone a step further by requiring mandatory carbon reporting for companies as well as pension investors. Before long, other countries will follow France. As principles go, the required disclosures are clear. However, there are implementation issues which need to be clarified as ESG goes mainstream.

The first one relates to terminology. Many pension plans are unclear about how to operationalise the principles of ESG for reporting purposes and where they can get the necessary data. Another challenge is how to benchmark against your peers in the absence of coherent common frameworks with historical data.

The recent ESG Reporting Guidance from the London Stock Exchange goes some way towards evolving a robust framework. It requires listed companies to provide an assessment of ESG factors on the business and their impact on financial performance. However, some of these impacts are difficult to quantify because: climate science is inexact, social impacts can also be qualitative and hard to evaluate, and governance disasters are hard to anticipate.

These difficulties, however, are only indicative of the birth pangs of a new era where ESG is going up the corporate agenda thanks to many initiatives.

At the most basic level, they are raising awareness of the importance of ESG risk factors. Beyond that, they are providing some basic tools and methodologies to identify them, quantify them and mitigate them.

They are an essential step towards creating a new mindset about mega risks that modern societies face and the necessary consensus on how to respond in ways that help our societies, our businesses, our citizens and our end investors.

~ A French pension plan

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[1] Source IPE "Top 400 asset managers" published in June 2017 and based on AUM as of end December 2016.

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[4] Based on market capitalization as of September 30, 2017

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