Expecting the unexpected

How pension plans are adapting to a post-Brexit world

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Amundi
ASSET MANAGEMENT

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Foreword

Amundi has a commitment to being your trusted partner. As part of that commitment, we endeavour to help our clients make more-informed investment decisions. That is why we are pleased to again work with Amin Rajan from Create Research to bring you valuable insights for the pensions industry.

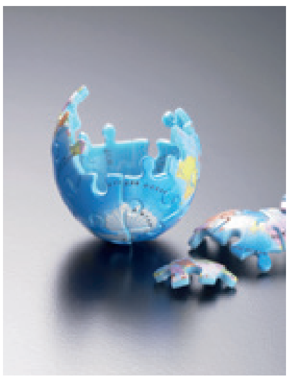
The need for innovation and new methods of finding return is more important now than ever. After eight years of a low yield environment and market uncertainty, many are realising that traditional asset allocation models may no longer be appropriate. This uncertainty has increasingly become the norm and with major headwinds such as Brexit looming large, it is not expected to end in the near future.

Created specifically for pension providers but appropriate for all large institutional investors, *Expecting the unexpected: How pension plans are adapting to a post-Brexit world* goes into detail on the factors that are influencing return and the drivers of innovation in both investment strategies and asset allocation modelling. Based on a survey of 169 pension plans across Europe and followed up by structured interviews, the report explores topics such as the use of consultants in developing mandates, the increasing importance of ESG strategies and the use of ETFs in portfolios. The report also has several case studies providing an insider view on how your peers across the European pension marketplace are approaching innovation from various perspectives.

We hope you find this report both informative and useful in helping you meet your investment goals.

Pascal Blanqué

Deputy Chief Executive Officer,
Global Head of Institutional Business,
Group Chief Investment Officer



Acknowledgements

This report presents the results of the third annual survey of European pension plans launched by Amundi Asset Management and CREATE-Research. Each year, the survey topic is chosen by asset owners in a private poll.

Two related topics have been chosen for this year's survey: first, the likely impact of the rising populist tide marked by Britain's vote to leave the European Union, followed by the election of a populist president in America; and the innovations needed to survive the resulting turbulent investment landscape.

My foremost thanks go to the 167 pension plans across Europe who participated in the survey. Many of them have provided unstinting support over the years, creating an impartial research platform that is now widely used in all the fund jurisdictions around the world.

My sincere thanks also go to Amundi Asset Management for sponsoring the publication of this report without influencing its findings in any way. Their arms-length support has helped to canvass all shades of opinion and present the findings in an impartial manner.

My grateful thanks also go to IPE for helping to conduct the survey and especially to its editor Liam Kennedy for his wise counsel and constructive support throughout the project.

Finally, I would like to thank two colleagues: Lisa Terrett for managing the survey and Dr Elizabeth Goodhew for editorial support.

After all the help I have received, if there are any errors and omissions in this report, I'm solely responsible.

Amin Rajan

Project Leader
CREATE-Research

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1 Executive summary

Introduction and aims

One definition of insanity, according to Albert Einstein, is to do the same thing over and over again and expect different results.

Pension plans across Europe have taken this message to heart. They have realised that they have a stark choice in this surreal era of negative yields: continue doing what they have been doing all this time and march nobly off a cliff, or adapt and change.

Most have chosen the latter in the belief that quantitative easing (QE) by central banks in America, Europe and Japan has reset the rules of investing, sidelining the conventional wisdom of the last 60 years. The past is no longer a guide to the future.

The outright purchases of bonds by central banks and the accompanying zero-bound policy rates prevented a rout turning into a 1929-style depression after the collapse of Lehman Brothers in 2008.

> The greatest danger in times of uncertainty is not the turbulence; it is to act with yesterday's logic.
>
> Peter Drucker

However, after eight years, they have also resulted in an unprecedented distortion of asset values through convictionless trades. Rates on nearly $15 trillion of sovereign bonds have gone into negative territory. Yet the global economy continues to face severe headwinds: growth remains sub par in all the key regions.

More importantly, although central bank action was supposed to be exceptional and temporary, there is little sign of normalisation.

If anything, the boundaries of the unconventional policies are stretched to the extreme with the arrival of negative interest rates. The resulting manipulation of markets and financing of government deficits is becoming a new orthodoxy.

As if that is not enough, the risk of sliding into a world of competitive and angry nationalism has risen sharply because of two recent events: Britain's vote to exit the European Union (Brexit), with far-reaching consequences for the European Union as an economic power; and America's election of an overtly nationalist administration, with far-reaching consequences for global trade and security.

Old certainties are gone. What will take their place is unclear at this stage.

Risks are being stacked up like a wedding cake.

Investors now find themselves on a journey into the unknown.

Against this background, this survey report aims to present an assessment from European pension plans on three pertinent issues:

— how will the new tide of nationalism affect financial markets over the rest of this decade?

— what asset allocation approaches are likely to be adopted?

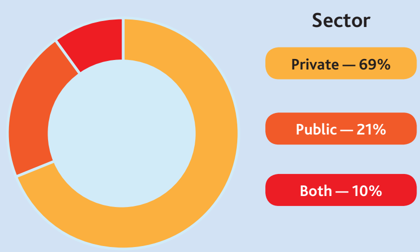
— which investment innovations are likely to deliver acceptable results in the volatile environment of this decade?

These questions were pursued in a pan-European survey covering 169 pension plans, with combined assets under management of €1.76 trillion. The survey was followed up by structured interviews with 30 senior executives. The survey provided the breadth, the interviews the depth. Details are given in Figure 1.0.

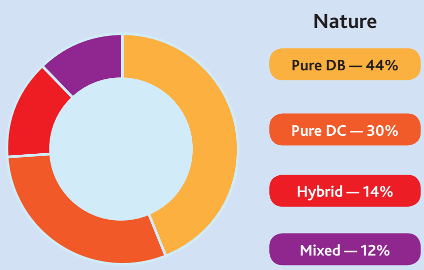
The next page presents our headline findings. It is followed by five themes that expand on them.

Figure 1.0

What sector does your pension plan cover? (% of respondents)



What is the nature of your plan?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Headline findings

1. Markets are mispricing the risks from the current tide of nationalism

Brexit is yet another headwind for global growth. Its economic impact will be felt in the UK but it could potentially morph into a wider EU problem reminiscent of the 2011-13 Greek crisis.

The Brexit vote is the canary in the coal mine. It presages the politics of fragmentation. Donald Trump's victory threatens old certainties about America and its role in the world. For now, nobody knows what will replace them. All our crystal balls are broken.

> Will President Trump implement what Candidate Trump promised? Or will he be constrained by the traditional checks and balances once in office?
>
> An interview quote

After these momentous votes, the markets nose-dived only to recover just as quickly. The rebound confirmed the age-old truism: markets rarely price in big political outcomes until they are faced with them.

After the sugar highs, populist policies fail under their own contradictions. Markets are poor predictors of their impacts.

Hence, investors now face an extra layer of uncertainty, as investing continues to become a high-wire act while asset prices are artificially inflated by the QE flood.

Unsurprisingly, therefore, our survey respondents do not see Brexit as promising anything resembling a happy ending: 96% expect increased volatility; 74% expect increased contagion susceptibility between markets; and 68% expect higher funding deficits.

Indeed, the impact on deficits was most immediate as the Bank of England lowered its policy rate.

The number of UK pension plans in deficit rose to 4995 from 4854 at the end of May 2016. Funding ratios fell close to their lowest recorded level, stretching average recovery periods from ten to fifteen years.

Theme 1 gives more details (p.9)

2. Asset allocation will be driven by an agnostic search for value

QE has brought forward future returns. The dream combination of high returns and low volatility delivered by QE may soon be history, as its potency wanes under the structural influence of ageing demographics, falling productivity and rising inequalities.

The 36-year old bull market in bonds will be ending, as the new US administration embarks on its ambitious plans for infrastructure spending and tax cuts.

In this surreal scenario, the asset choices of pension plans will rely on four themes deemed most conducive to value creation.

First, investing will remain an agnostic relative value play, in this era of exponential risks.

Second, the money in motion will go into asset classes with pockets of value opportunities. These include global equities, private equities and emerging market assets. US equities will need a strong earnings boost to sustain their current inflated valuations.

Third, investors will also be drawn into asset classes with pockets of fair value. These include off-market bespoke investments such as infrastructure and alternative credit; and traditional investment grade corporate bonds.

Fourth, even if secular stagnation becomes a reality in the face of heightened political risks, negative interest rates are not quite the one-way bet they seem.

Instead, they imply the 'greater fool' theory of investing. Much can go wrong – especially loss of policy credibility – as central banks go on printing money that has no asset anchor to reduce financial instability and moral hazard.

Theme 2 gives more details (p.10)

3. As investment returns have morphed into a monetary phenomenon, innovation has become essential

The 2008 crisis fast-forwarded the adoption of investment innovations that emerged in the last decade with varying degrees of success. Some will outlast the crisis that propelled their rise in the first place.

Looking ahead, however, pension plans want their asset managers and pension consultants to improve the old as well as create the new.

They want innovations to improve four features of existing strategies: fees and charges, risk-return trade off, liquidity and client engagement.

They also want innovations in the investment process to recognise that investment returns are turning into a monetary phenomenon, influenced more by central bank largesse than economic factors.

The art of investing has to venture beyond financial theories so as to develop new insights into how to make money while central banks and markets remain caught in a tight embrace, while facing new political risks.

There should be a clear line of sight between asset owners' needs and innovations.

Themes 3-5 give more details (pp.11-13)

Theme 1

Brexit has transformed the politics of fragmentation in the European Union and created new risks

It is hard for investors to distinguish an event that causes periodic volatility from the one that is a game changer.

The immediate aftershock of the Brexit vote saw the MSCI World Index plunge by 7% and European stocks by 11%. If the fall was steep, so was the rebound, once the Bank of England announced fresh monetary stimulus. Markets were reassured that central banks would be even more dovish. Complacency set in.

However, our survey respondents expect the second and third round effects of the vote to be highly negative (Figure 1.1):

- 92% expect increased market volatility
- 76% expect a further disconnect of market prices and their fundamentals
- 74% expect increased contagion susceptibility between global markets
- 68% expect higher funding deficits
- 54% expect lower investment returns
- 46% expect reduced risk appetite.

Brexit will impact on asset valuation mostly via political contagion instead of a hit on corporate profits. Its impact in the UK could potentially morph into a wider EU problem, bringing about a replay of the 2011–13 Greek crisis.

According to the European Council of Foreign Relations, there have been 34 anti-EU referendum demands in 18 countries – the ones in France and The Netherlands could be a political minefield. The populist wave in the US may well hit Europe.

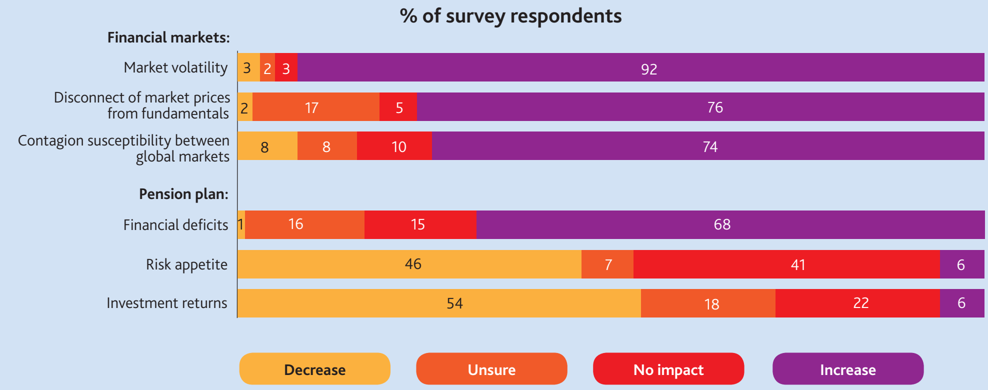
Who will fund the increased deficit spending of the new US administration is unclear. China, Japan and Saudi Arabia may not be so eager if new trade barriers are created.

In today's interconnected world, it was hard enough to connect the dots on all possible risks due to the experimental policies of central banks.

Populism has added yet another layer of uncertainty for pension investors, who are now braced for more market-moving events. It is hard for them to distinguish an event that causes periodic volatility from the one that is a game changer.

Figure 1.1

What impact will Britain's decision to leave the European Union have on financial markets and your own pension plan over the next three years?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

> With Brexit, some 55 treaties will have to be renegotiated. The final deal will have to be ratified by 36 national and regional bodies.

> The most powerful country in the world may reverse its policy on almost every key issue.

Theme 2

Asset allocation will be a relative value game while interest rate normalisation remains a distant prospect

The 'don't fight the Fed' refrain has pushed investors up the risk curve, turning investing into an agnostic search for relative value.

The strong dual rally in bonds and equities to record levels in July 2016 sent out highly contradictory signals, as did the mass dual sell-off that followed in September.

Declining yield – and even negative yield in Europe and Japan – presages recession and rising risks. Booming equity prices, on the other hand, imply higher economic growth and rising earnings.

In this Alice in Wonderland world, investors are buying bonds for capital appreciation and stocks for income.

The 'don't fight the Fed' refrain has pushed investors up the risk curve in an agnostic search for value. Certain classes of equities will be cheap because bonds remain expensive.

Accordingly, Figure 1.2 presents pension plans' investment preferences over the next three years, distinguishing between *most favoured* (top half of the figure) and *least favoured* (bottom half).

The *most favoured* are deemed to offer either value opportunities or fair value. The first camp includes global equities, private equities, quality equities and emerging market assets. The second camp includes infrastructure, alternative credit real estate and quality bonds.

In contrast, the *least favoured* asset classes are deemed to offer value traps or over-valuation. The first camp covers a motley collection of long-only and alternative assets. The second one covers sovereign bonds and regional equities.

Much will depend upon the size, shape and timing of the likely fiscal stimulus of the new administration in the US. The resulting rise in inflation and interest rates may well hit bond values. Its extent, however, will be moderated by the prevailing structural changes in the global economy due to an ageing population, falling productivity and rising inequalities.

Equity markets will be exposed to political risks arising from nationalism, bringing to an end the dream combination of high returns and low volatility inspired by QE.

Figure 1.2

What asset classes will be most suited to meet your pension plan's needs over the next three years?

Most favoured

Value opportunities	% of respondents
Global equities	57
Private equities	42
High quality equities	38
EM equities	30
EM government bonds	30
EM corporate bonds	30

Fair value	% of respondents
Infrastructure	50
Alternative credit	46
European investment grade corporate bonds	34
American investment grade corporate bonds	31

Value traps	% of respondents
Domestic equities	22
European equities	20
Real estate (equity-based REITs)	20
Hedge funds	15
Small cap equities	15
Gold	8
Commodities (excluding gold)	7
Currency funds	3

Overvalued	% of respondents
High yield bonds	28
Real estate (debt)	25
European government bonds	24
US equities	13
US government bonds	12
Japanese equities	6

Least favoured

Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"We start from a position where the best way to make money is not to lose it."

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

Theme 3
Distorted markets are hastening innovations

As the old ways of investing lost their relevance in the new landscape, the search for new ways intensified.

The 2008 crisis was a watershed. Asset class diversification failed when it was most needed. Risk failed to generate returns. Pension liabilities began a relentless rise under the weight of rising discount rates and ageing populations.

As the old ways of investing lost their relevance in the new landscape, the search for new ways intensified. They focused on some 30 innovations that had emerged gradually in the last decade. Their adoption gained fresh traction after the 2008 crisis. They fell into four categories: asset classes, product themes, asset allocation tools and asset vehicles.

A summary version of their scorecard so far is shown in Figure 1.3, which shows the top three items in each category. Fuller details are given in Section 3. Three salient points are worthy of note.

First, there are standouts across the patch. Private debt is the most obvious one. US-style credit markets are now emerging in Europe, as banks have withdrawn to repair their damaged balance sheets after the 2008 crisis. Other standouts include risk factor investing, absolute return investing, multi-asset class funds and ETFs.

In each case, early adopters report net positive outcomes. Their future growth prospects remain favourable.

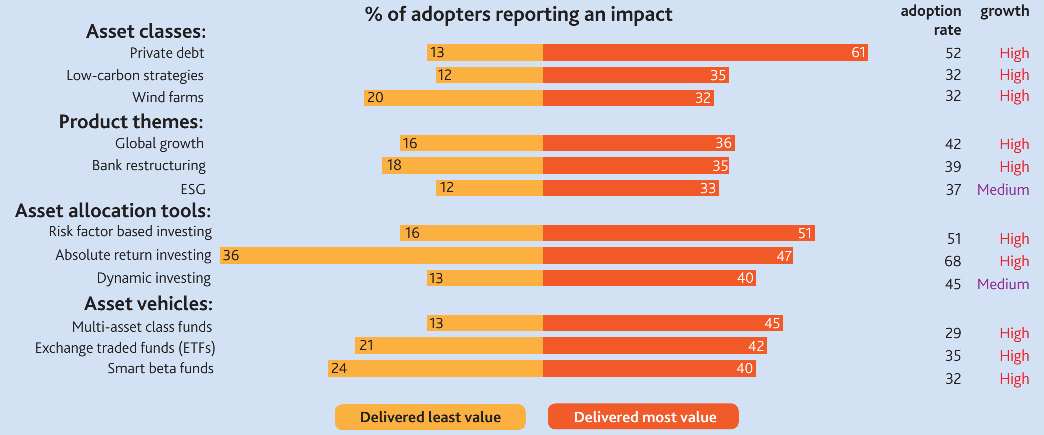
Second, going forward, four innovations will be game changers: they will outlast the crisis that promoted their rapid rise:

- low-carbon strategies and environmental, social and governance (ESG), because markets will be increasingly pricing in the effects of climate change initiatives after the COP21 Paris Conference in 2015 and HFCs (hydroflurocarbons) Kigale Conference in 2016
- risk factor investing, because it is proving more robust than asset class-based diversification
- multi-asset class funds, because their fees are based on net performance across all chosen asset classes, unlike single product mandates
- ETFs, because they allow investors to slice and dice the universe in pursuit of emerging opportunities.

Third, as asset values have become distorted, pension plans have been more open to new ideas to enjoy early mover advantage. Innovation is the key.

Figure 1.3

Investment innovations that delivered most value since the 2008 crisis: their current adoption and future growth



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"Large pension plans have jettisoned the tick-box approach to climate change and are now seeking early mover advantage."

"ETFs allow us dynamic asset allocation at low cost and full liquidity."

Theme 4
Investment innovations should seek to improve the old as well as create the new

The rapid ascendancy of asset vehicles – like ETFs and smart beta – underscores the need for active managers to up their game.

Against the backdrop of their relatively favourable experience of innovations in this decade, our survey respondents were asked whether further innovations could deliver value (Figure 1.4, left-hand chart). Nearly two thirds responded 'yes'.

But the endorsement is not unqualified. Pension plans want asset managers to improve various design features of their existing offerings in order to improve their outcomes (Figure 1.4, right-hand chart). Fees and returns top the list.

This emphasis on improving the old rests on a simple imperative: around 75% of pension assets in Europe currently rely on active asset managers. But earning market-beating returns has proved hard while asset prices remain distorted by unconventional monetary policies.

The rapid ascendancy of low-cost vehicles – like ETFs and smart beta – underscores the need for active managers to up their game in a changing landscape (as we argue in Theme 5).

For now, it is worth emphasising that unlike their physical counterparts, investment innovations do not have predictable outcomes or a definable shelf life. Most of them are about customisation that meets clients' needs. Results depend on their intrinsic merits as much as on how clients use them.

Hence, client engagement is becoming critical. When asked how often their asset managers have involved their clients when innovating the products that clients buy from them, the responses were:

— invariably (12%)

— frequently (19%)

— occasionally (42%)

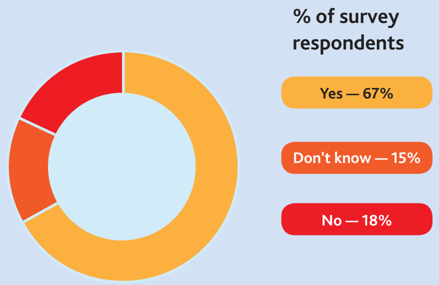
— rarely (27%).

Current engagement models need a big makeover to create a direct line of sight between client needs and innovations.

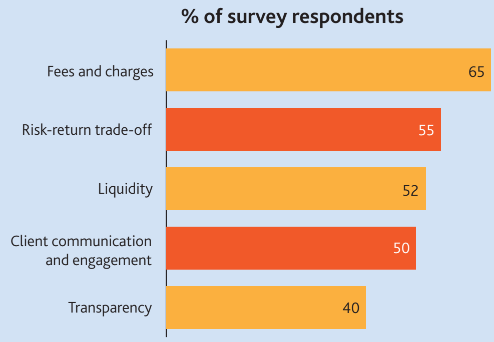
The changes should enable asset managers to understand their clients' specific needs, solicit new ideas by tapping into their expertise, manage expectations of what can and can't be delivered in markets driven more by politics than economics, minimise 'wrong time' risks in buying and selling, highlight proactive buying opportunities and deliver bespoke research.

Figure 1.4

Overall, do you think that further investment innovations can deliver value to your plan over the next 3 years?



In which areas do asset managers and pension consultants need to make significant improvements if they are to receive mandates from your plan in future?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"Markets are adaptive and self correcting. Active management seems out of fashion while markets are distorted. But it'll come back."

"The best innovations minimise investor foibles and choose the right time. Success is as much about 'when' as 'what'."

Theme 5

As investment returns have morphed into a monetary phenomenon, it's time for radical thinking

Crisis is often the mother of innovation.

When asked to rate the contribution of asset managers and pension consultants in the challenging environment since 2008, the majority of pension plans rate it as '*excellent*' or '*good*' – with asset managers scoring notably higher (Figure 1.5). Asset managers also score higher than pension consultants in specific activities, as shown on p.20 in Section 2. However, our post-survey interviews unearthed two salient points.

First, despite higher scores, examples of 'groupthink' and rear-view investing are widespread – mostly due to heightened uncertainty.

Second, any assessment needs to make a distinction between *qualifiers* and *differentiators*. Qualifiers are the basics that an organisation needs to get right in order to survive. Differentiators, on the other hand, are what give it a competitive edge. The positive scores in the survey largely relate to qualifiers.

Few asset managers and pension consultants have yet to differentiate themselves with strategies that seek to capitalise on the fact that investment returns today are mostly a monetary phenomenon: influenced far more by the regular largesse of central banks than economic fundamentals.

Asset prices are both the result of monetary action and a factor influencing it. This implied circularity is great when markets are doing well but disastrous when they reverse – unless global growth picks up dramatically. Evidently, central banks will continue to support markets in today's highly indebted financial environment, where a big market correction can wipe out a large chunk of the supporting collateral.

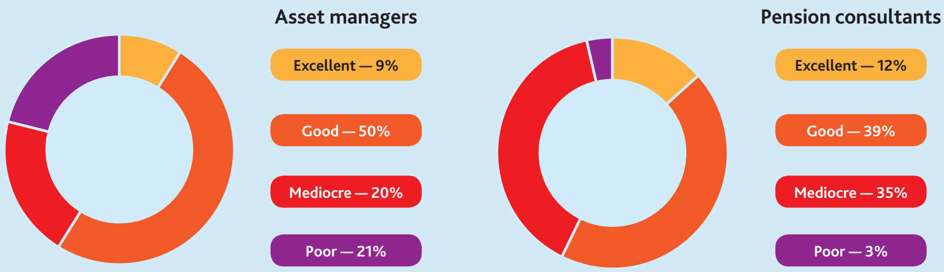
In this complex dynamic, the art of investing has to go beyond financial theories and develop new insights into how to make money when politics more than economics drives the markets. Newer lenses are needed to study markets from perspectives as diverse as politics, psychology and philosophy.

It is not enough to blame central banks for the sorry state of investing today. The best that asset managers and pension consultants can do is to turn the challenges into opportunities.

Crisis is often the mother of innovation.

Figure 1.5

As a pension plan, how would you rate the contribution of your asset managers and pension consultants in helping to meet your investment goals since the 2008 crisis?



Source: Amundi Asset Management / CREATE-Research Survey 2016

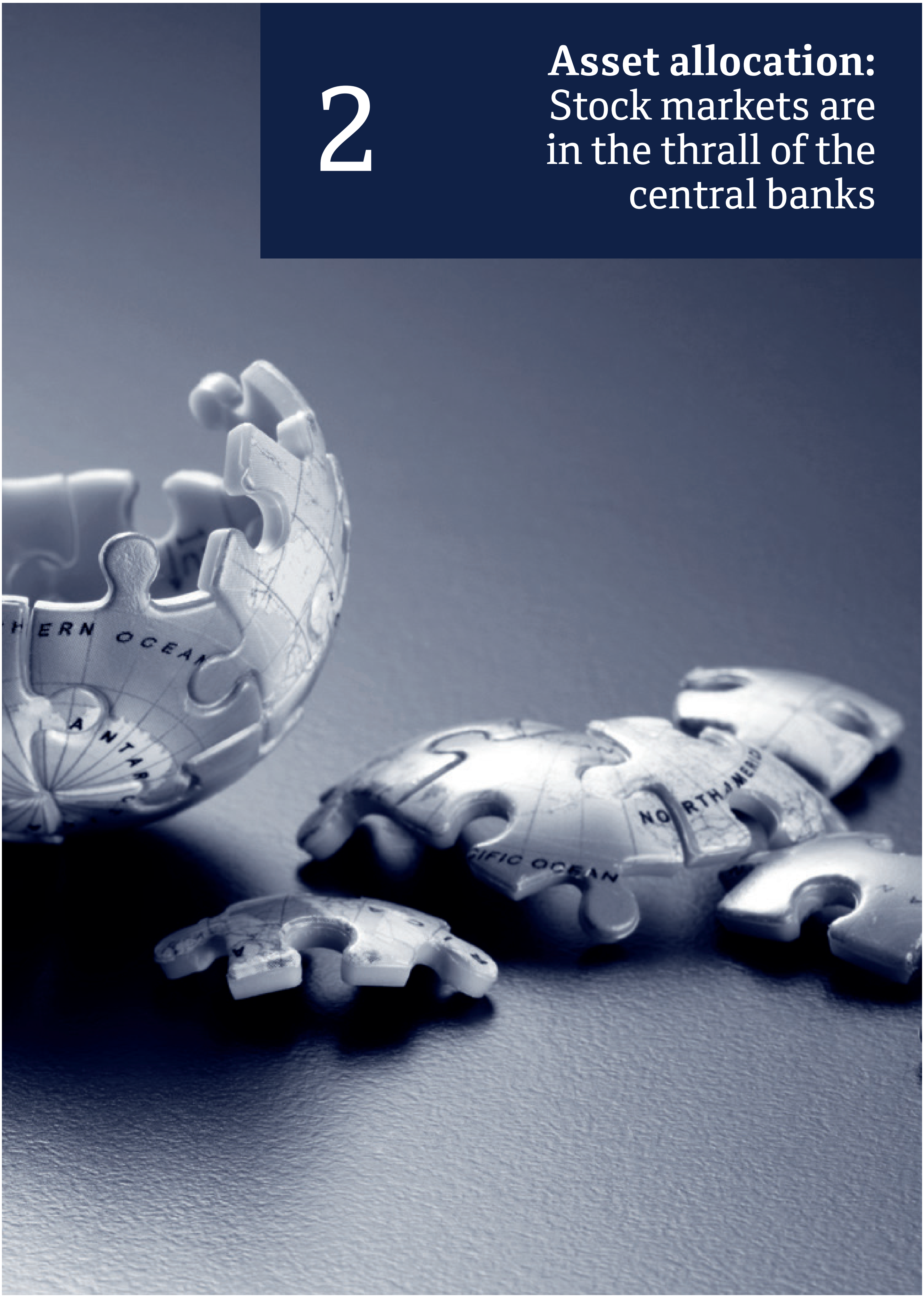
Interview quotes

"Loose monetary policies will last for years. They require new ways of thinking and investing."

"Investing is heavily nuanced, as markets evolve like a biological organism. Ideas based on finance theory are not enough."

2

Asset allocation: Stock markets are in the thrall of the central banks



Overview

Aims

Taking a three-year forward look, this section explores the following questions:

— what factors will drive the investment returns of pension plans?

— how has Britain's vote to exit the European Union unleashed a new tide of nationalism?

— what asset classes are likely to be most favoured against a background of the resulting top-down risks?

— which areas of investing need improvements to cope with today's market distortions caused by central bank action?

> The ripple effects of the Brexit vote will be more evident when the 'divorce' negotiations kick off in earnest.
>
> An interview quote

Key findings

A. Return drivers

As central bank action delivers diminishing impacts, markets will remain in an era of low returns and high volatility. Key drivers of returns will be:

— the outlook of the global economy

— central bank policies

— Britain's exit from the EU

— geopolitical risks

— fears of a hard landing in China after its explosive credit growth.

Investors will be enjoined to continue their delicate balancing act. On the one side, recognising that QE has brought forward future returns for most asset classes; and on the other side, knowing that central banks are unlikely to allow big market corrections that would wipe out the financial leverage that supports today's valuations.

B. Impact of Brexit

Brexit has crystallised pension investors' deeper fears that the anti-globalisation policies will hurt the global economy and create new political risks.

A cloud of uncertainty hangs over the new trading arrangements, as Brexit reshapes the politics of fragmentation in the European Union. The process is unlikely to have a happy ending for investors. There is also a lot of uncertainty around the policies of the new administration in America.

C. Asset choices

Global equities and high quality equities will be favoured for their excess yield over bonds.

Off-market illiquid assets such as infrastructure, private equity, real estate and private debt will be favoured, as the search for uncorrelated absolute returns intensifies.

Corporate bonds and emerging market assets will continue to attract fresh inflows, as investing increasingly becomes a relative value game.

Sovereign bonds will become less attractive, as the potency of monetary action diminishes, forcing governments to adopt more muscular fiscal policies, as promised by the incoming administration in the US.

D. Areas needing improvement

The art of investing needs to go beyond financial theory. A dual rally in bonds and equities in July 2016 followed by a mass dual sell-off in September showed the severity of market distortions currently.

They highlighted the need for improvements that asset managers and pension consultants need to make in two specific areas:

— risk management: to take account of the subtle nuances in the evolving investment scene

— tactical investing: to single out value opportunities from value traps in today's risk-on/risk-off cycles.

Rising populism is yet another headwind for global growth

> Debt is future demand brought forward. Its current size is unlikely to stimulate demand soon to a level that will stoke up inflation, which central banks so keenly want.

Since the 2008 crisis, the conventional investment wisdom has been increasingly sidelined by central bank action in the West. With the latest negative interest rates on 50-year Swiss sovereign bonds, investors are pushed to the extremities of asset price distortion.

With fresh rounds of quantitative easing announced recently by the Bank of Japan and the Bank of England, pension plans see little prospect of normalisation for the foreseeable future, while growth in the global economy remains sub par.

So when asked to identify the drivers of investment returns over the next three years, at least one in every two survey respondents identified the same five: growth in the global economy, unconventional monetary policies of central banks, populism marked by Britain's exit from the European Union, geopolitical risks and a hard landing in China (Figure 2.1).

A number of salient points emerged from our follow-up interviews with senior executives in the pension plans covered by the survey.

First, with successive rounds of QE since the 2008 crisis, diminishing return has set in. Growth remains anaemic. In the meantime, global debt has ballooned from $147 trillion in 2008 to $205 trillion in 2015. Debt is future demand brought forward. Its current size is unlikely to stimulate demand soon to a level that will stoke up inflation, which central banks so keenly want. Despite firing on all cylinders, even US growth remains sub par, with a collapse in productivity and subdued inflationary expectations.

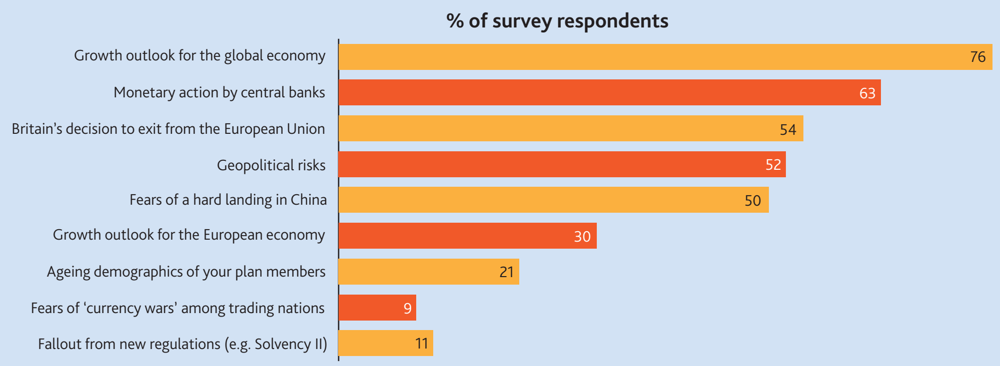
Second, ultra-loose monetary policies have undermined price discovery for all assets. The parallel regulatory changes under the Dodd-Frank Act in the US and MiFID in Europe have undermined liquidity in bond markets. Investors now find it hard to distinguish a market event that causes periodic volatility from one that is a game changer.

This will continue, since central banks want to avoid a recession in today's highly indebted and overleveraged financial environment, where a big market correction can wipe out a big chunk of the underpinning collateral.

Third, Brexit will impact on asset valuations mostly via political contagion rather than via immediate impact on corporate earnings (see INSIGHTS on the next page). Initially, its economic impact will be felt in the UK but it could potentially morph into a wider EU problem that brings about a replay of the 2011-13 Euro crisis. The campaign promises made by the new US president carry major risks for the global economy and security. Brexit has already caused

Figure 2.1

What factors will drive the investment returns of your pension plan over the next 3 years?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

> The current level of gilt yield implies 30 years of stagnation, if history is any guide.

> The Fed is walking a slippery tightrope, after over-inflating the asset values. Its exit strategy is fraught with danger.

a flight to safety, driving yields even lower. The process is not promising anything resembling a happy ending on current reckoning (see INSIGHTS box below).

Fourth, emerging markets are witnessing another credit explosion. Their debt:GDP ratio has risen from 150% to 195% since 2010. In the past four years alone, China's ratio has shot up by 50 percentage points.

Nonperforming loans in excess-capacity overleveraged sectors such as steel and energy will intensify pressure to recapitalise the banking system. So large is the credit injection that much of it cannot be absorbed efficiently.

Evidently, most new debt goes to pay off old obligations rather than invest in value-creating activities. China's rebalancing from exports to consumption also carries risks of policy errors, as shown by the authorities' futile attempts to boost stock markets in the summer of 2015. China will continue to remain a wild card with a lot in its favour and a lot against it.

The European economy will continue to recover. But, as in the US and Japan, its growth will remain sub par over the next three years.

No one knows the end game of QE, with the countless convictionless trades it has generated. In today's interconnected world, it is hard to join the dots on all possible risks.

Many improbables may occur given that the entire global monetary system is influenced by the experimental policies of central banks. Pension plans are braced for market-moving events that may result in big gains or big losses.

Their search for better ways of investing has intensified.

Neither the EU nor the euro zone are likely to disintegrate anytime soon. The risks from Brexit are on a slow fuse and could potentially roil the markets, as did the Greek crises in 2011–14.

Interview quotes

China continues to kick the credit can down the road. Its sugar highs don't last long.

The tide of globalisation is turning, as growth has faltered and inequalities have widened.

Insights

Stock markets are too complacent about the Brexit aftermath

In the immediate aftermath of the Brexit vote, European stocks fell by 11% and the MSCI World Index by 7%. If the fall was massive, so was the rebound – once the Bank of England announced a monetary stimulus. Markets rallied in the belief that major central banks around the world would be even more dovish. But the fallout from Brexit is simply postponed.

To start with, sterling's stunning decline to 168-year lows will push up inflation without boosting the UK exports, since these are much less price sensitive. As businesses reassess their prospects, the UK may well sink into recession, especially if the prospect of trade deals proves illusory and constitutional hurdles proliferate.

Currently, there is a cloud of uncertainty hanging over the terms of the 'divorce' and the new trade deals. As the UK has turned migration into a 'red line' issue, negotiations could turn protracted and acrimonious. Why would the EU accommodate deluded Brexiters?

EU leaders are naturally keen to prevent other member states from leaving. Political minefields lie ahead with the upcoming elections or referenda in Austria, Hungary and Italy, and demands for outright exit from the EU in France and Holland.

Neither the EU nor the eurozone are likely to disintegrate anytime soon. The risks are on a slow fuse and could potentially roil the markets, like the Greek crises in 2011–14.

The real significance of the Brexit vote and the subsequent result of the US presidential election is that they show how nationalism now triumphs over globalism. Populism is on the rise in Europe. Global trade and growth are at risk. The lacklustre growth in the global economy faces yet more headwinds.

The Bank of England's timely monetary action has calmed the markets at the expense of hitting pension plans. The total deficits of the UK plans in the Pension Protection Fund 7800 Index fell to 78% after the Brexit vote – close to the lowest level ever recorded of 76.5% in May 2012. The number of plans in deficit rose to 4995 after the vote, from 4864 before the vote.

Our recovery period is now extended from ten to fifteen years, so big is our plan deficit.

A UK Pension Plan

Asset allocation will be about separating signal from noise in an agnostic search for relative value

Asset prices have been rising faster than the real economy everywhere. QE has brought forward future returns. Rates will remain even lower for even longer. Ageing bull markets are on bumpy terrain with sky-high valuations. Unknown unknowns dominate the risk scene, especially after the US presidential election. Normalisation remains a distant prospect. But pension investors also know that times of high risk are also times of big opportunity.

Normalisation remains a distant prospect. But pension investors also know that times of high risk are also times of big opportunity.

Against this sombre background, our survey identified eleven asset classes that are likely to be favoured over the next three years by at least 25% of respondents (Figure 2.2). Their preferences reflect four investment themes that would be most conducive to value creation at a time when financial markets remain disconnected from the fundamentals (see INSIGHTS box on the next page).

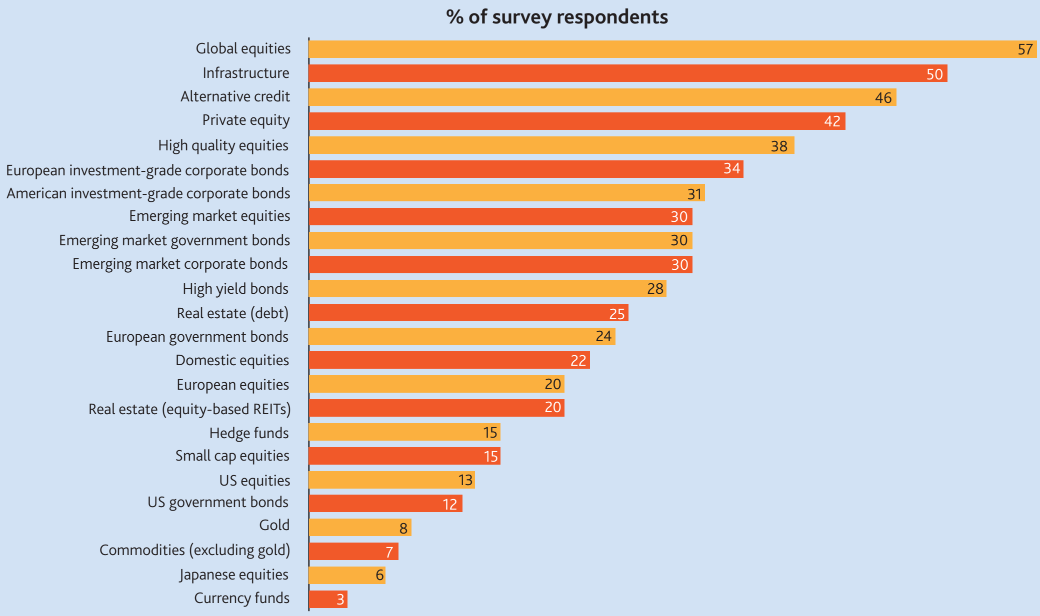
The first theme reflects the search for yield. Global equities and high-quality equities will be favoured for their excess yield over bonds. Further expansion in earning multiples will be acceptable because these asset classes remain the biggest beneficiary of fresh stimulus from central banks in China, Europe and Japan. In contrast, markets in Europe, Japan and the US have narrowed: their momentum has weakened with fewer – mainly tech – stocks now powering their rise. The likely fiscal stimulus in the US could change that.

The second theme favours off-market bespoke investments such as infrastructure, alternative credit, private equity and real estate – all delivering uncorrelated absolute returns in excess of equities. They are also perceived as being less sensitive to rate rises on account of their in-built floating rate structure. Alternative credit is likely to see the biggest increases in allocations. Real estate allocations will be directed towards value-added and opportunistic categories, since prime and core assets are deemed overvalued.

The third theme treats investing as a relative value game, while the QE tide continues to lift all boats. This will favour under-valued, under-researched

Figure 2.2

Which asset classes will be most suited to meet your plan's investment goals over the next 3 years?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"Bond markets are dysfunctional, like a barometer that gives inaccurate readings."

"Investors are buying bonds for capital appreciation and stocks for income. How odd!"

Negative rates sound like a one-way bet but they rely on the 'greater fool' theory of investing

and under-loved assets in four areas: investment grade bonds, high yield bonds, and emerging market equities and bonds. Arguably, emerging markets are coming into favour not because of their renewed dynamism but because they offer better relative returns – in the near term.

The final theme cautions against overcapitalising on negative interest rates on sovereign bonds in parts of Europe. Yes, the rates may sink even further into negative territory and generate windfall gains. Negative rates sound like a one-way bet but they rely on the 'greater fool' theory of investing. A lot can go wrong on this journey into the unknown, reflecting desperation on the part of central banks.

They cannot go on defying market gravity with paper money that has no asset anchor to reduce financial instability and moral hazard caused by cheap money policies. Central banks are no longer viewed as omnipotent institutions. They may well be reaching the limits of what they can achieve with QE. Hence, net new money into sovereign debt is likely to be limited.

Another reason is that rates are likely to rise in the US to fund the new deficit spending. The longest bull market in bonds in history may be coming to an end.

Interview quotes

"New allocations will end up in unlisted illiquid markets with good return expectations."

"Making money in the surreal environment of negative rates requires exceptional skills or exceptional luck."

Insights

Perverse messages from bond and equity markets

The strong dual rally in bonds and equities to record levels in July 2016 was a rare phenomenon, as was the mass dual sell-off in September; both telling contradictory stories.

Declining yield – and even negative yield in Europe and Japan – presage recession, rising risks and a fall in capital expenditure, if the history of the past 50 years is any guide. The current yield on a US 10-year Treasury note implies a 60% probability of recession in 2017 and inflation at 1.4% a year through 2021.

On the other hand, booming equity markets imply higher growth, rising earnings and strong corporate spending. This seeming disconnect is explained by two idiosyncrasies in today's financial markets.

First, many of the purchasers of sovereign bonds are compelled by regulators to buy them at any price. Pension plans in many EU jurisdictions are obliged to offset long-term liabilities with assets of similar duration. Likewise, banks buy bonds to comply with the new rules that govern their risk profile. Most of all, central banks themselves have become the biggest buyers of bonds as part of the QE programmes. On the supply side, governments have not been issuing bonds in large volumes. In the face of artificial excess demand, bond markets are like broken crystal balls with little predictive powers.

Second, on the equities side, unconventional monetary policies have taken valuations to heights well above their historical norms. The "don't fight the Fed" refrain has pushed investors up the risk curve. The buyback boom on both sides of the Atlantic, fuelling stock markets, is mostly the bi-product of ultra-low rates. High stock prices are not evidence of a healthy economy. Rather, they reflect the fact that there are too few opportunities for productive investment as companies grapple with the secular stagnation scenario, while the global debt mountain shows no sign of shrinking.

The question uppermost in the minds of investors worldwide is whether corporate earnings can rise in a modest growth world. While improvements in economic fundamentals have been slow, top-down factors such as loose monetary policies, political concerns in Europe, the Chinese credit boom and oil prices have taken centre stage in driving up equity prices. The process will receive fresh impetus with the proposed stimulus package in the US.

The resulting expansion in the earnings multiple is mostly justified by the fact that equities now deliver better yield than bonds in most markets – contrary to conventional wisdom – while their respective valuations remain distorted. In this Alice in Wonderland scenario, we have to remain invested as our liabilities are maturing rapidly due to ageing demographics and our coverage ratio remains below 100 due to ultra-low discount rates.

A Dutch Pension Plan

Today's market distortions require radical thinking on the part of asset managers and pension consultants

Our survey asked pension plans to assess the value added by asset managers and pension consultants via their eight core activities since the crisis.

Taken as line items, asset managers were rated as '*good*' or '*excellent*' in five of them by at least 50% of respondents (Figure 2.3). They include investment returns, strategic asset allocation, stock selection and portfolio construction, risk management and access to new investment insights.

The corresponding figure for consultants is three. They include listening and understanding their clients' unique needs, strategic asset allocation and risk management.

In both cases, the scores for fiduciary management and tactical asset allocation are notably low. Taking them in turn, fiduciary management has gained traction but it remains a nascent phenomenon outside the Netherlands because of seeming conflicts of interest. Tactical asset allocation has gained ascendancy with risk-on/risk-off cycles that characterise markets today. But it requires enhanced investment capabilities that can turn volatility into opportunity. These are scarce currently.

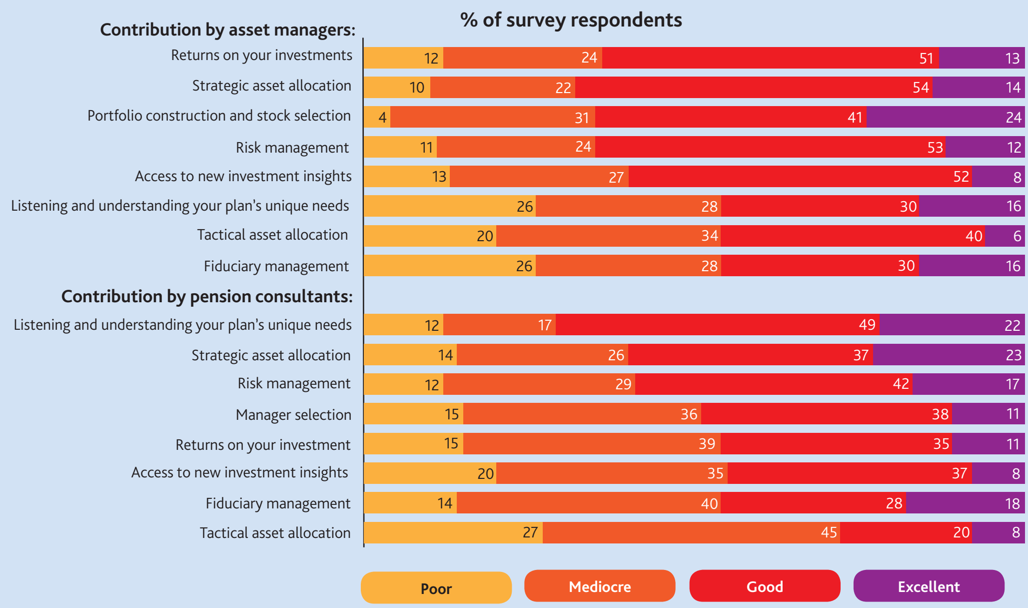
In the wake of the crisis, pension plans have taken on board a number of innovations, as we shall see in Section 3. But that does not detract from an over-riding message from our post-survey interviews: while new asset classes and asset allocation tools are needed, there is also plenty of scope to improve the old approaches while the bulk of old money is tied up in old asset classes.

Risk management and tactical investing were widely singled out as areas that need big improvements.

While new asset classes and asset allocation tools are needed, there is also plenty of scope to improve the old approaches while the bulk of the old money is tied in old asset classes.

Figure 2.3

How do you rate the contribution of the following activities of your asset managers and pension consultants in helping you to meet your plan's investment goals since the 2008 crisis?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"We want to pick the bandwagon premium when momentum is working."

"Where else is opportunity, if not in volatility? How many asset managers know how to capitalise on it?"

The art of investing needs to go beyond financial theory

Taking them in turn, the prevailing risk models came unhinged in the last decade when asset managers and pension consultants could not foresee the two vicious equity bear markets; nor did they detect the time bomb concealed in cheap money; nor did they anticipate asset class correlations going through the roof; nor did they imagine the unintended consequences of the mark-to-market rules that turned the US sub-prime crisis into a global disaster.

Evidently, they missed the subtle nuances of the newly evolving investment scene that was far removed from conventional wisdom.

Much the same observation applies to tactical investing. Rarely have the markets been so wild; nor is there a precedence of so many asset classes fluctuating so uniformly.

In an era where politics more than economics drives the markets, the art of investing needs to go beyond financial theory and develop deeper expertise in anticipating price distortions thrown up by wild periodic risk-on/risk-off cycles in which value traps and value opportunities are hard to distinguish.

Investment ideas and their embedded risks need to be stress-tested under extreme macro-economic and geopolitical scenarios via personal judgement based on insights and foresights gained by deploying a multiplicity of lenses. Descriptions based solely on finance theories are not enough to understand the behaviours of markets.

Interview quotes

"There is a need for fresh thinking on how to generate returns while central banks dominate the markets."

"In hindsight, periods of market stress have been good entry points."

Insights

Time to avoid groupthink and rear-view mirror investing

Our funding level has dropped from 104% to 74% since 2007. Falling discount rates have been the main reason – but not the only one. Investing has become complex: the old investment assumptions on risk, returns, correlation and mean reversion do not seem to work.

The main reason is that investment returns have been turned into a monetary phenomenon. They are influenced far more by the regular stimulus of monetary authorities than by corporate earnings from the real economy. The perception that the US Federal Reserve would always intervene if markets tumbled has now been deeply ingrained in investor psyche.

As a result, the price of financial assets is thus both the result of monetary action and a factor influencing it. The implied circularity is great when markets are doing well, but disastrous when they reverse. Thus, while central bank action continues to override fundamental value drivers, fat-tail events may well become the norm.

Asset managers have responded with numerous innovations. We have adopted some of them, like risk-factor diversification and multi-asset funds – with varying degrees of success. They have been necessary but not sufficient.

Peer risk, agency risk and market risk have given rise to excessive herding.

Specifically, groupthink and rear-view investing no longer work in today's environment. Standing out from the crowd is often a precursor to being right. The past is a poor guide to the future while markets remain distorted. For our contrarian style of investing, two basics need to be enhanced.

To start with, the investment process needs additional lenses that look at markets from perspectives as diverse as politics, psychology and philosophy. Financial theories alone can no longer be relied upon. Anticipating central banks' next move may be hard. But it is vital to stress-test portfolios under different policy regimes.

Additionally, our asset managers and pension consultants must have an open, honest dialogue with us on what can and can't be delivered while markets are behaving so irrationally. As part of expectations management, asset managers must avoid making exaggerated claims about future returns.

A German Pension Plan

3 Investment innovations: Recent experience and future imperatives

Overview

Aims

The 2008 crisis was a watershed. Asset class-based diversification failed when it was most needed. Risk failed to generate return. Pension investors' liabilities began a relentless rise. A lethal combination of rising discount rates and ageing demographics made it harder to honour the pension promise.

That required trying out new approaches hitherto not tested by time or events. Since the 2000-02 equity bear market, many investment innovations have emerged. But their substantive adoption has occurred since the 2008 crisis, as old ways of investing no longer worked and end-investors sought out new ways of earning decent returns.

Some involve new asset classes, some involve new product themes, some involve new asset allocation tools and some involve new asset vehicles.

This section provides an assessment of their past track record and future prospects. It highlights:

— their current adoption rate amongst European pension plans

— their impacts so far in the unusual environment since the crisis

— their future adoption rates, as Brexit adds another layer of uncertainty over the next three years

— the new areas at which the main thrust of innovation should be directed over the rest of this decade.

Below, we highlight the innovations that have attracted a significant number of early adopters and their outcomes so far.

Key findings

A. Current adoption rates

a. New asset classes

Out of nine newcomers, private debt has had the highest adoption rate, followed by low-carbon strategies and wind farms. On balance, they have also delivered most value. Their popularity will increase strongly as late adopters begin to make allocations.

Looking ahead, renewable energy is set to be a disruptive catalyst after the 2015 Paris conference on climate change and the 2016 Kigale HFC (hydrofluorocarbons) conference.

b. New product themes

Out of seven newcomers, four have had a moderate adoption rate: global growth, bank restructuring, ESG and technology. They have also delivered most value so far.

Looking ahead, ESG and global growth (centred on emerging markets) will continue to attract fresh inflows.

c. New asset allocation tools

Of the seven newcomers, absolute return investing has had the highest adoption rate, followed by factor-based investing, dynamic investing and liability-driven investing. They have also delivered most value.

Each has risen to the challenges thrown up by ultra-loose monetary policies and will continue to transform the art of asset allocation.

d. New asset vehicles

Of the eight newcomers, four have had the highest adoption rate so far and have also delivered most value to their investors: multi-asset class funds, exchange traded funds, smart beta and diversified growth funds. Together they are transforming the investment landscape.

e. Future innovations

Pension plans want the next wave of innovation to improve the old while creating the new.

Improvements need to focus on: fees and charges, risk-return trade off, liquidity, client engagement and transparency.

They also need to adopt multi-disciplinary lenses in the investment process.

> There should be a clear line of sight between the needs of end-investors and innovation.
>
> An interview quote

New asset classes are emerging for a new age

As mentioned in the introduction on the previous page, four sets of innovations have gained added impetus since the crisis. The first one relates to asset classes (Figure 3.1). It presents three sets of information under separate headings:

— the current adoption rate amongst our sample of respondents, classified here as *high* (over 50%), *moderate* (26%-50%) and *nascent* (25% and below)

— the future adoption rate, classified similarly to the current adoption rate

— impacts so far, defined as delivering either *most value* or *least value*.

a. Current adoption rate

Only one emergent asset class has scored a *high* adoption rate: private debt, as reported by 52% of the respondents. As identified in our 2016 survey, its rise has been propelled by the partial withdrawal of commercial banks from lending to medium-sized enterprises, as the 2008 crisis ravaged their balance sheets and ushered in a new restrictive lending regime under Basel III.

Three newer asset classes have notched up a *medium* adoption rate so far: low-carbon strategies (32%), wind farms (32%) and farmland (28%). In each case, special factors have been at work.

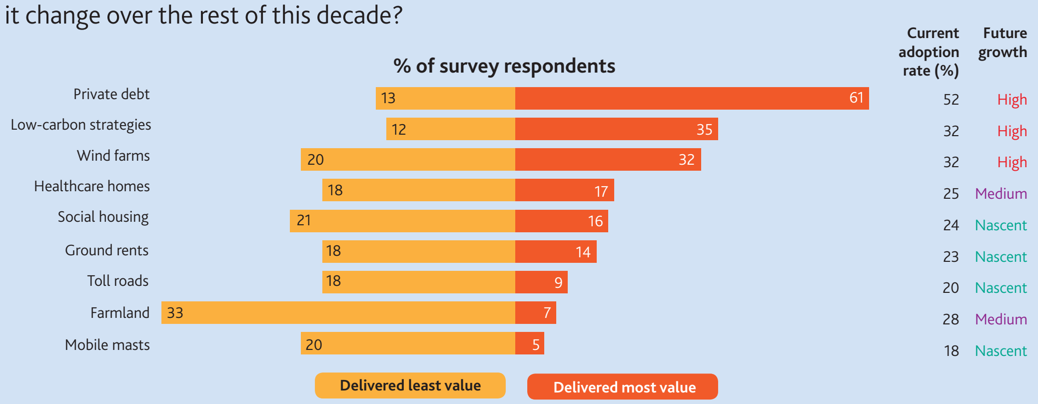
To start with, the conventional green energy indices have not delivered high returns as they have not factored in the risk associated with the actual *timing* of initiatives aimed at mitigating the effects of climate change (see INSIGHTS box on the next page). In the case of wind farms and farmland, the opportunity set has expanded slowly owing to the long lead times involved in setting up the necessary infrastructure, owing to stringent planning regulations.

Finally, the adoption rates for the rest of the asset classes in Figure 3.1 have been *nascent*. Asset classes such as healthcare homes (25%), social housing (24%), ground rents (23%), toll roads (20%) and mobile masts (18%) are subject to strict regulatory controls in all jurisdictions. They offer steady returns over a long period at a time when funding deficits have favoured asset classes that deliver quicker returns. Investors seeking illiquidity premia have preferred to make allocations to more established asset classes such as private equity, real estate and infrastructure, as shown in Section 2.

Only one emergent asset class has scored a high adoption rate: private debt, as reported by 52% of the respondents.

Figure 3.1

Which new asset classes delivered most value to your plan and which delivered least value since the 2008 crisis? What is the current level of their adoption and how will it change over the rest of this decade?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"The US-style credit markets are finally emerging in Europe, as banks withdraw to repair their damaged balance sheets."

"The main limitation of new asset classes is that most of them are not so scalable: they require customised vehicles."

b. Impacts so far

There is a direct correlation between adoption rates and reported impacts.

The three asset classes with the highest adoption rates so far have also received *most value* from them: namely, private debt (61%), low-carbon strategies (35%) and wind farms (32%).

At the other extreme, the bottom four asset classes in Figure 3.1 have reportedly delivered *least value* so far: ground rents (18%), toll roads (18%), farmland (33%) and mobile phone masts (20%).

c. Future adoption

Over the rest of this decade, three asset classes are likely to power ahead: private debt, low-carbon strategies and wind farms. Each will experience strong tailwinds from different sources.

Private debt is expected to benefit from any rate-hike cycle in the US due to its use of floating rate structures and low default rates. Low-carbon strategies will get an added boost after the 2015 COP21 Conference in Paris and the arrival of dynamic carbon-hedging strategies. Wind farms will similarly get an added boost, as nations seek to meet their obligations under the COP21 protocol that marks a credible transition to green energy.

Over the rest of this decade, three asset classes are likely to power ahead: private debt, low-carbon strategies and wind farms.

Interview quotes

“Actions on climate change are no longer equated to ‘tree hugging’ and ‘backdoor socialism'.”

“Many of these new asset classes have long time horizons. It is perhaps too soon to make a judgement on them.”

Insights

Renewable energy is a disruptive catalyst

What mobile phones did to land lines, renewable energy will do to fossil fuel grids over time.

Research shows that 50% of the global institutional asset base is currently managed under the UN Principles for Responsible Investment (PRI). Around 25% of global companies already have exposure to ‘green’ revenues. Around a quarter of investment professionals around the world seek non-financial information when making investment decisions. Around 10% of portfolio managers have received formal training in the art of ESG screening. Around 170 countries have agreed to phase out hydrofluorocarbons (HFCs) the harmful planet-warming chemical.

The recent COP21 conference in Paris and the latest VW scandal have provided stark reminders of how financial risks are concealed in climate change as well as weak corporate governance. We are seeking to convert that risk into returns. The old stereotype that linked ESG to worthy social goals instead of sound investing is changing, as our planet migrates towards a low-carbon future. Around 70 countries – including China and the US – will ratify the Paris treaty by the end of 2016.

To start with, in pursuit of better returns, ever more investors are undertaking ESG screening at the portfolio construction stage than is widely recognised. The distinction between ESG as a product and as a process is blurring. Thus, ESG investing is far more prevalent than implied by the reported AuM.

Furthermore, ‘green’ equities no longer take a back seat in asset portfolios, as institutional investors continue to divest themselves of climate-change-inducing industries like coal and oil that are exposed to the high risk of stranded assets.

Finally, a more explicit move towards clean emergent technologies is signaled by the arrival of the so-called dynamic decarbonised indices designed for investors preferring passive funds.

These newer versions differ from their traditional pure-play ‘green’ peers. The latter do not cater for the risk attached to the actual timing of climate change mitigation initiatives worldwide. The dynamic versions overtly hedge this risk as it arises.

Effectively, they provide a free option on carbon. While actions on decarbonisation are pending, the dynamic indices target a low tracking error with respect to a traditional passive index. But as actions are implemented and the climate change risk is properly priced in, the dynamic version is duly rebalanced and begins to outperform the unhedged peer.

A French Pension Plan

No dominant product themes have as yet gained momentum, but some have already delivered value

With each product theme, end-investors have been looking for decent returns as well as psychic benefits in line with their beliefs and values.

Until around the turn of this century, investing had been described in binary terms: equities and bonds, long-only and alternatives, actives and passives, opportunistic and buy-and-hold.

Since then, as the asset industry's footprints have expanded globally via more investor segments and legal jurisdictions, products with specific themes have increasingly come on stream to meet the unique needs arising from the resulting diversity.

Since the 2008 crisis, product innovations have centred on seven themes (Figure 3.2) to capitalise on investment opportunities opened up by their respective structural dynamics. With each theme, end-investors have been looking for decent returns as well as psychic benefits in line with their beliefs and values.

a. Current adoption rate

Of the seven themes, four have had a *medium* adoption rate (defined as between 26% and 50%). They include global growth, favouring specific regions (42%); bank restructuring, promoting new forms of lending (39%); technology, favouring efficiency gains (33%), ESG, conforming to changing societal values (37%); and an ageing demographics, creating new needs for retirees (31%).

Two themes remain in the *nascent* stage: Shari'ah, relying on Islamic principles of finance (25%); and social change, covering gender, age and sexual diversity (24%).

After the 2008 crisis, global growth (favouring emerging markets) was all the rage. The indiscriminate selling in the wake of the 'taper tantrum' in 2013 has since reversed partially. Technology, in contrast, has retained its glamour. All other themes appear to have attracted a critical mass of early adopters.

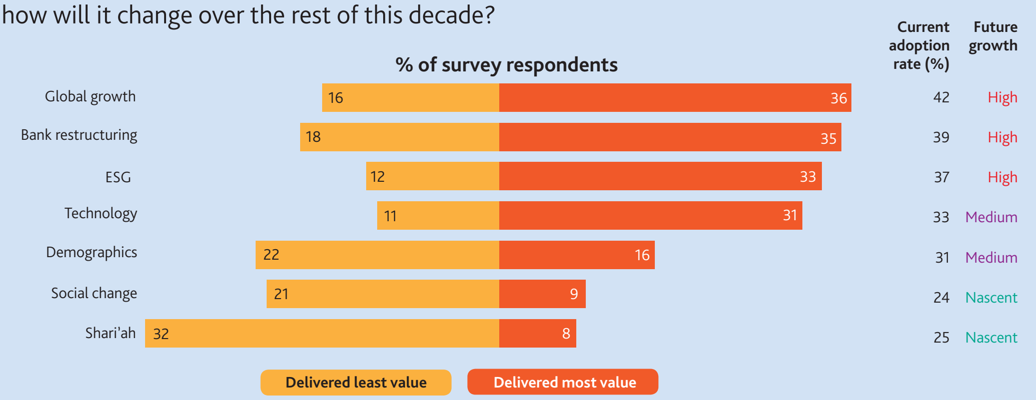
b. Impacts so far

Once again, there is a positive correlation between the rate of adoption and impacts. Those themes attracting a higher adoption rate also report that they have gained most value from their chosen themes. Global growth receives the most favourable rating (36%), followed by bank restructuring (35%).

At the other extreme, two themes are reported as delivering *least value*: social change (21%) and Shari'ah (32%). In the first case, the main reason is that a distinct lifestyle for emergent social groups is taking a while to develop. In the second case, the exclusion of financial stock has worked against good results in what has been a long equity bull market. But the early interest in Shari'ah funds is underpinned by: its focus on businesses founded on productive activities that generate fair and legitimate profits; its high standards of disclosure

Figure 3.2

Which new product themes delivered most value to your plan and which delivered least value since the 2008 crisis? What is the current level of their adoption and how will it change over the rest of this decade?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"The US economy is at stall speed: a premature rate-hike cycle by the Fed could tip it into recession and hit all assets indiscriminately."

"Emerging markets have switched to a lower gear, but they still remain a key growth engine of the global economy."

that minimise informational asymmetries; and its exclusion of businesses that engage in activities deemed unacceptable, like alcohol, tobacco and pornography.

c. Future adoption

So powerful and pervasive is the impact of central bank monetary action that the intrinsic merits of these product themes cannot override them. The distortions are hitting the good, the bad and the ugly indiscriminately.

So, while rates remain low and markets are driven by monetary policy, only three themes are likely to see *strong* adoption over the rest of this decade: global growth, bank restructuring and ESG.

Taking them in turn, emerging markets are likely to experience better growth dynamics than developed markets. That explains why emerging assets have come into favour this year, although doubts persist as to whether their rise is merely an agnostic search for yield (see INSIGHTS box below).

Moving on to bank restructuring, their rise is attributed to the emergence of bond markets in Europe, which will reduce the role of banks in corporate lending under Basel III. Europe is expected to follow the US model where private debt accounts for 75% of total corporate lending, compared with 10% in the Eurozone and 28% in the UK. The restructuring is seen as providing decent returns with low correlations.

Finally, ESG will have strong tailwinds, as governments seek to meet their contractual obligations after the Paris conference on COP21 and the Kigale conference on HFC.

The asset industry, too, is upping its own game.

ESG will have strong tail winds, as governments seek to meet their treaty obligations after the Paris conference on COP21.

Interview quotes

"The Paris conference on climate change could be a game changer for ESG."

"Europe's banks require big recapitalisation before they become big lenders again. Long-term investors are stepping into the void."

Insights

The emerging market rose has lost its bloom – or has it?

For nearly two decades, global growth has been the dominant driver of financial markets. China's double-digit growth started a supercycle in commodities that powered asset values in all emerging markets.

A negative feedback loop is now at work. Sub-par growth in China and developed markets combined with depressed commodity prices are the main sources of weakness in the global economy. So, the question is where will growth come from? The answer is not easily found.

The US has recovered from the crisis faster than Europe and Japan. But its growth remains sub par. Credit risk in its non-financial sector is elevated and rising to a point where a further rate rise may create severe refinancing risks. Doubts persist as to whether the US economy has reached the escape velocity that finally cuts it loose from the deflationary mindset.

Europe shows signs of recovery, thanks to the 'wealth effect' from quantitative easing by the European Central Bank. Both growth and productivity, however, remain sub par. The Greek debt crisis has shown all too clearly how Europe will continue to stumble from one crisis to another without a co-ordinated policy response.

Japan remains a big challenge. Nothing that the Bank of Japan (BOJ) does has any lasting effect on the economy due to the deflationary mindset and fast ageing population. The BOJ now owns over one third of the JGB market. It is the market.

Finally, it is hard to interpret the huge positive net flows into emerging markets this year. It may mean that growth will be resuming soon, after the traumas of the last three years started by the 'taper tantrum' in 2013, which wiped out ten years of stellar returns on emerging market assets.

Markets have since bounced back in Argentina, Brazil, India, Russia, Mexico and South Africa. We are unsure whether QE is encouraging investors to ignore their inherent risks. Is it all about a relative value trade in pursuit of yield that is unconnected with the title 'emerging market'?

On the other hand, it is hard to ignore the improving fundamentals in many countries with strong reform agendas. Not all emerging markets are created equal. The gap between the best and the worst performers is widening. Stock picking is the name of the game.

An Irish Pension Plan

Market distortions are promoting new asset allocation tools

Old-timers like risk factor-based investing, absolute return investing and liability driven investing (LDI) have gained fresh momentum.

After two punishing bear markets in the last decade, the conventional investment wisdom on risk, returns, diversification, mean reversion and fair value was side-lined. The scale of losses in the 2008-09 crash forced heavy introspection.

Seven asset allocation tools gained traction (Figure 3.3). Old-timers like risk factor based investing, absolute return investing and liability driven investing (LDI) gained fresh momentum. Relative newcomers like dynamic investing and unconstrained investing suddenly came of age. Together, they have changed the face of asset allocation.

a. Current adoption rate

Of the seven tools, two have had a *high* adoption rate (defined as being above 50%): factor-based investing (51%) and absolute return investing (68%). The first of these was a direct response to the failure of the old-style asset class based diversification that failed miserably in the 2008 crisis when correlation between historically lowly correlated assets rose sharply. Absolute return investing, on the other hand, gained added popularity as pension plans sought positive returns in an environment of random risk-on/risk-off cycles – a major feature of the investment scene after the crisis.

Three tools have had a *medium* adoption rate: dynamic investing that aims to capitalise on periodic price dislocation after the crisis (45%); LDI that seeks to immunise risk as plan liabilities mature (42%); and unconstrained investing that mandates asset managers to 'go anywhere' in search of good returns as yields drop dramatically (36%).

Finally, two tools are still at the nascent stage of adoption: risk parity investing that uses leverage in the traditional equity-bond portfolio to spice up the overall returns (24%); and portable alpha that involves investing in areas with no correlation to the market (19%).

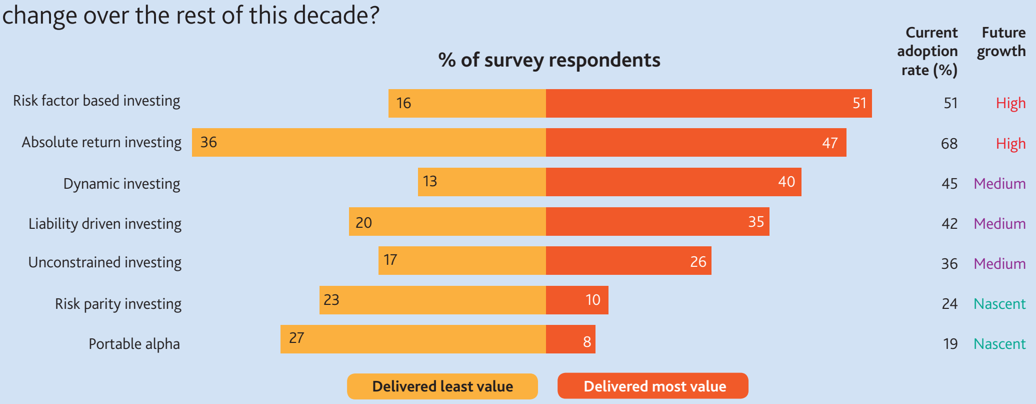
b. Impacts so far

At least one in every five respondents report that five of these tools have delivered *most value*. They are: factor-based investing (51%), absolute return investing (47%), dynamic investing (40%), LDI (35%), unconstrained investing (26%).

At least one in every five respondents who have used these tools also report that they have delivered *least value*: absolute return investing, because of excess volatility and distorted market value (36%); LDI, because of ultra-low discount rates (20%); risk parity investing, because of unexpected turns in the benchmark interest rates (23%); and portable alpha, because of persisting market distortions (27%).

Figure 3.3

Which new asset allocation tools delivered most value to your plan and which delivered least value since the 2008 crisis? What is the current level of their adoption and how will it change over the rest of this decade?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"Factor-based investing is becoming part of our investment DNA."

"When valuations are so out of sync with fundamentals, dynamic investing is essential in periods of big dislocations."

Early evidence shows most of these new tools are not like the fads that characterised investment innovations in the last decade.

The fact that the incidence of *most value* exceeds the incidence of *least value* in five cases suggests that the majority of these tools have risen to the severe challenges thrown up by the surreal investment environment of this decade. On balance, early evidence shows that most of these new tools are not like the fads that characterised investment innovations in the last decade.

c. Future adoption

Two tools are likely to experience *high* growth: risk factor investing, because it takes a granular look at risk; and absolute return investing, because pension plans are using their liabilities as benchmarks.

Three tools will experience *medium* growth: dynamic investing, because periodic market dislocations will remain the norm; LDI, because risk immunisation will remain the name of the game; and unconstrained investing, because the search for yield will intensify as ever more sovereign bonds attract negative rates.

Two tools will remain in the *nascent* stage: risk parity because of the fears that the 36-year-long bull market in bonds will have to come to an end; and portable alpha, because alpha will remain illusive, ephemeral and expensive while markets are distorted.

Interview quotes

“Uncorrelated absolute return investing has taken us into alternatives to achieve meaningful diversification.”

“The search for yield is promoting ‘go-anywhere’ type strategies.”

Insights

The rise and rise of factor-based investing

Three key assumptions underpin our entire investment approach today.

First, we are now in an environment of historically low real returns – for all asset classes. Second, the dramatic drop in bond market liquidity will remain a feature of investing. Safe assets are traded much less, while their block sizes have shrunk and dealer inventories have dropped. Third, we have to get used to frequent fat-tailed events of the sort witnessed in the last two years. The flash crash in US treasuries in October 2014 was a 7-sigma event. The Swiss currency attack in January 2015 was a 29-sigma event. The German interest rate rise in May 2015 was a 4-sigma event. The Chinese equity crash in August 2015 was a 6-sigma event.

Hence, we have implemented various changes. To start with, we have developed a strong focus on the long term, with realistic absolute return targets. We have also implemented a risk-centric diversification that uses a number of risk factors to achieve specific risk and specific return objectives. The framework identifies the seven micro risks that drive returns: value, size, momentum, market, low volatility, term and credit. It also looks at macro risks such as inflation, interest rate and economic growth. Return premia are simply rewards for taking risks with them.

This approach has evolved from the concepts first popularised by value investing, where investors focused on a subset of stocks with attractive relative or absolute valuations.

This evolution is now transforming the traditional diversification based on asset classes, which came unhinged in the 2008 bear market when it was most needed. It did not allow for the fact that seemingly diverse asset classes can have common risk factors that nullify the benefits of any diversification based purely on asset classes. For example, outwardly, equities and corporate bonds are like chalk and cheese. Yet they share at least three common risk factors: inflation, volatility and currency.

Our experience shows that factor-based investing can improve risk-adjusted returns when applied across asset classes. Some have even produced excess returns. However, there is no guarantee that historical returns associated with various factors will persist in future.

Factor returns can be cyclical and individual factors can underperform over a long period. Much depends upon investors’ ability to stay the course during periods of under-performance. Still, the approach marks an advance in the way we allocate our assets.

A Danish Pension Plan

With their lower costs and greater flexibility, asset vehicles are transforming the investment landscape

ETFs are viewed as a vehicle for slicing and dicing the investment universe to pursue the newly emerging opportunities.

Prior to the 2008 crisis, only three vehicles featured prominently in pension portfolios: cap-weighted indices, structured products that limited the downside risk and fund of funds. Since then, the number has grown rapidly (Figure 3.4).

a. Current adoption rate

Of the eight asset vehicles now in use, five have had a *moderate* adoption rate (defined here as between 26% and 50%).

They include ETFs (35%), smart beta funds (32%), multi-asset funds (29%), diversified growth funds (26%) and fund of funds (36%). The first three of these have had the fastest rise. By providing low-cost options, each is viewed as a game changer.

Taking them in turn, ETFs are viewed as a vehicle for slicing and dicing the investment universe to pursue the newly emerging opportunities (see the INSIGHTS box on the next page). Smart beta funds are seen as offering alpha returns, via specific factor exposures, at beta risk and beta fees. Multi-asset funds are seen as a cost-effective device to achieve broad diversification and periodic rebalancing with a single manager, thus doing away with the costly manager selection process.

At the other extreme, three vehicles are at the *nascent* stage (defined as below 25% adoption rate). They include diversified income funds (21%), lifecycle funds (21%) and structured products (20%).

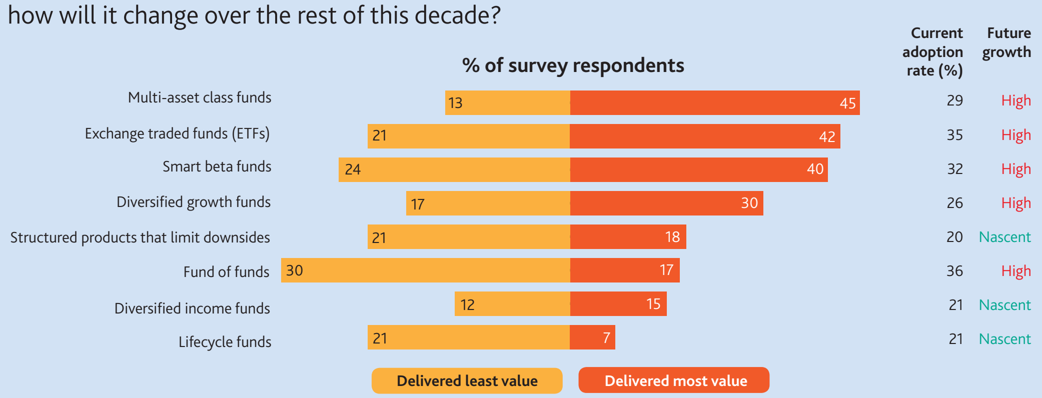
Taking them in turn, diversified income funds gained momentum mainly after 2014 when the search for yield intensified, as interest rates headed towards negative territory; similarly with lifecycle funds. The new money in defined contribution plans is going into these funds, while the old money remains locked into traditional equity-bond funds. Finally, structured products are not making headway because pension plans prefer to get downside protection via a broad diversification that is more cost-effective.

b. Impacts so far

Asset vehicles with the highest adoption so far also receive the highest positive rating on their impact. Four funds stand out as having delivered *most value*: ETFs (42%), multi-asset class funds (45%), smart beta (40%) and diversified growth funds (30%). In each case, a small minority of respondents also report *least value*, due to specific issues – with ETFs, for example, concentration on a single theme has delivered volatile returns. With multi-asset funds, their liquidity has been a challenge owing to the use of illiquid assets. With smart beta, mean reversion from recent highly inflated valuations have caused a gap between actual and expected factor

Figure 3.4

Which new asset vehicles delivered most value to your plan and which delivered least value since the 2008 crisis? What is the current level of their adoption and how will it change over the rest of this decade?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

Multi-asset funds are cheaper than single mandates, since their fees are based on the net performance across the chosen asset classes.

ETFs are the most disruptive innovation of the past twenty years. Their assets will double by 2020, from the current level of $3.3 trillion.

returns. With diversified growth funds, beta returns have been inevitable, with a very broad palette of assets.

At the other extreme, three asset vehicles are singled out as having delivered least value: structured products (21%), fund of funds (30%) and lifecycle funds (21%). The respective causes are: high fees for structured products, beta returns for fund of funds, and much recent adoption for lifecycle funds, which are meant to be a long-term story.

c. Future adoption
Three funds are likely to experience strong growth over the rest of this decade: ETFs, multi-asset funds and smart beta funds. The factors that have propelled their rise so far are likely to prevail at least over the rest of this decade – if not beyond.

As active funds have struggled to deliver in an environment where all market valuations are distorted by surreal central bank monetary action, the search for low-cost passives has intensified. Once compounded, costs are viewed as key sources of outperformance. Pension plans with big funding deficits and negative cash flows are forced to look for low-cost options.

They also remain deeply worried that whereas central bank action was meant to be exceptional and temporary, there is little sign of normalisation after eight years. Central banks remain at panic stations. The resulting market distortions have turned investing into a journey into the unknown, where asset vehicles provide greater flexibility than active funds.

Once compounded, costs are viewed as a key source of outperformance

Interview quotes

"Some of today's asset vehicles are transformational. Their popularity may outlast the crisis that provoked them."

"Negative rates and debt monetisation by central banks is the new orthodoxy. We're on a journey into the unknown."

Insights
ETFs have been a game changer – so far

We use ETFs to pursue specific themes, while gaining low-cost exposure to different markets, with intra-day pricing and trading.

Early results have been in line with our expectations. Hence, we aim to elevate the role of ETFs in three respects over the rest of this decade.

First, they are becoming the centrepiece in our core-satellite model. In our core portfolio of 60:40 equity-bond funds, plain vanilla ETFs and cap-weighted funds are replacing active funds. This has more than halved the cost of investing while our active funds have struggled to deliver value.

Second, we are also considering active ETFs to deliver specialist themes covered by the satellites – especially hedge fund and high yield. Their daily liquidity is a major plus for us. Our real estate portfolio lost 40% in 2008-09 when liquidity virtually dried up.

Third, we invest in multi-asset class funds that rely on ETFs to gain access to various asset classes. ETFs are also used for periodic tactical tilts and hedging.

Of course, we are aware of the inherent risks in our approach. With rapid proliferation in this decade, some 96% of individual ETFs and 85% of ETF assets are highly concentrated, covering narrow market segments such as gold, commodities, emerging markets and high yield. They are raising the asset class correlations. While minimising the idiosyncratic risk, ETFs may end up creating systemic risks.

For example, ETFs were blamed for helping to cause the 'flash crash' in May 2010, when the key US equity indices nosedived in a matter of minutes before rebounding just as quickly. Liquidity evaporated. Over 20,000 trades were executed at prices more than 60% away from their true value. But we think that ETFs were the victims of this debacle, not the culprits. We live in an era where investing is about riding the bandwagon when that helps.

Markets are about the rapid flow of information, and a low-cost systematic style of investing like ETFs – which eliminate at least some of the potential for human error – is better suited than active funds. Value investing will remain out of favour until we see normalisation of interest rates.

A Norwegian Pension Plan

Innovations should promote non-financial as well as financial alignment of interests

The current distortions in asset values will last while financial markets and central banks remain caught in a tight embrace.

One recurring message from our post-survey interviews is that the current distortions in asset values will last while financial markets and central banks remain caught in a tight embrace: both need each other. In the meantime, pension plans have to perform a delicate balancing act: capitalising on periodic opportunities as and when they arise while conserving their capital.

That means their asset managers and pension consultants have to raise their game. In particular, while they adopt new innovations (discussed earlier in this section), they should target improvements in four areas, as identified by at least one in every two survey respondents (Figure 3.5). These include: fees and charges, risk-return trade-off, liquidity and client engagement.

Taking them in turn, fees and charges are widely perceived as a key source of outperformance over time. The long prevailing 'heads-I-win, tails-you-lose' fee structure, based on a fixed percentage of assets under management, has proved untenable in today's low-return environment. It is akin to an option in which the upside is uncapped but the downside is limited to base fee. Pension investors want to see new approaches. Their current focus is on low base fee. But two other variants are on the table too. One of them includes low base fee and high watermarks that ensure that a performance fee is only paid when the fund exceeds the highest previous value reached by its cumulative returns. Another variant includes fees being paid on a rolling three-year basis or longer, with clawbacks in bad times.

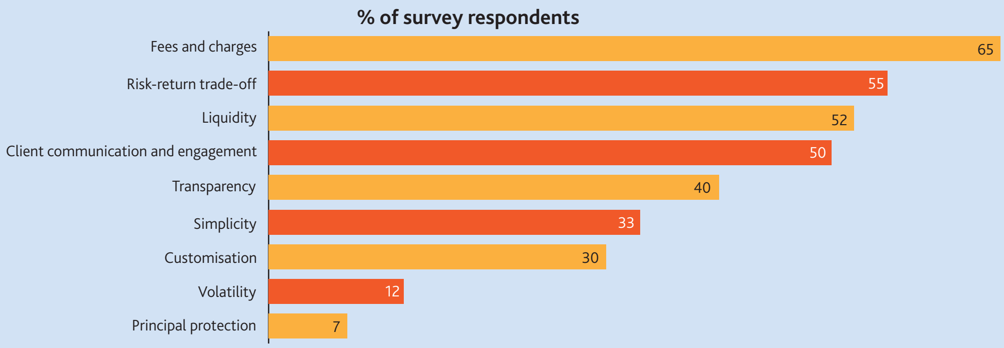
The second area singled out for improvement is risk-return trade-off. In the past, it mostly featured market risks tied with traditional business cycles. Now new risks have emerged and are largely reflected via liquidity and volatility. Returns are neither predictable nor stable.

Pension plans want their asset managers and pension consultants to understand these risks, their causes and their consequences. Of particular concern is the sequence of returns risk that hit pension investors after the crisis, when they realised that their portfolio value is determined not by average returns, but the realised sequence of those returns.

The third area identified as requiring improvement is liquidity. Paradoxically, liquidity is everywhere – just look at the balance sheets of central banks. Yet dysfunctional imbalances are emerging, where banks no longer perform their traditional market-making role due to new regulation. It now takes seven times as long for investors to liquidate their bond portfolios as it did in 2007.

Figure 3.5

In which areas do asset managers and pension consultants need to make significant improvements, if they are to receive mandates from your plan in future?



Source: Amundi Asset Management / CREATE-Research Survey 2016

Interview quotes

"High fees were put in place when AuM was low. But they have not changed much with its explosive growth over the past 20 years."

"Liquidity is a big unknown. We don't know what returns our assets will deliver when we cash out."

Although asset managers and pension consultants cannot control liquidity, they need to factor in the new reality when predicting future returns. The quoted value of assets can differ markedly from the actual value.

The final area requiring improvement is client engagement; without it, hopes will continue to run ahead of expectations.

Investing is now increasingly seen as a loser's game: one in which the winner is not the one with the best strategy, but the one who makes fewest mistakes. In today's surreal environment, pension investors are especially exposed to 'wrong time' risk as well as 'regret' risk. The aim of greater engagement is to help minimise them. The scope for more joined-up thinking remains big.

In sum, pension investors want non-financial as well as financial alignment of interest to be achieved by investment products that are fit for purpose and meritocratic incentives that ensure that gains and pains are equitably shared.

Investing is now increasingly seen as a loser's game: one in which the winner is not the one with the best strategy, but the one who makes the fewest mistakes.

Interview quotes

"Will there be liquidity when the 36-year bull market in bonds comes to an end? A scary thought!"

"Most of today's de-risking tools have not been tried and tested by time or events. We don't know what they will deliver."

Insights

The global system is awash with liquidity, yet shortages persist in specific markets

Markets have become prone to seismic shifts. In April 2015, we were hit by an extreme event when the Swiss National Bank announced the removal of the SFR1.20 cap on the franc against the euro. The Swiss franc instantly surged 39% against the euro and equities dropped by 10%.

Our pension plan's unhedged foreign investments took a big hit. As if that were not enough, soon thereafter, the Swiss government was the first to sell the benchmark 10-year debt at negative interest rate. With our members' benefits guaranteed at around 7% of savings by law, Swiss pension plans face a tough future as their liabilities mature.

The paradox of today's investing is that central banks have pumped trillions into the financial markets via quantitative easing, yet liquidity can evaporate in the blink of an eye for almost all asset classes. A key culprit here is regulatory shrinkage. It has forced banks to set aside higher levels of prudential capital while also prohibiting them from engaging in market-making activities.

Being long-term investors, our immediate response has been to demand a higher premium for illiquid assets and tighten up our credit quality checks. But our trustees still worry whether, in the long term, there will be buyers of these assets if we are turned into forced sellers for some reason.

Accommodative monetary policies have not only created a delusion of liquidity. They have also distorted the pricing of risk and correlations between assets in the process. The gap between quoted prices and transacted prices of assets is getting wider whenever everyone is rushing out from crowded trades.

Our asset managers and pension consultants need to dive deep into the fixed income space at the most granular level to understand the causes, symptoms and consequences of various risks. With maturing liabilities, we are overweight in three areas where quoted prices are not a good guide, due to liquidity shortages.

The first area is sovereign bonds. If and when inflation picks up, or when the interest rate cycle turns, the scope for losses is big. The second area is real estate where valuations are high and the scope for losses correspondingly large if we are turned into forced sellers. The third area is emerging market debt where liquidity almost dried up in the summer of 2013, when the Federal Reserve first decided to dial down its bond buying. It is hard to know what 'fair value' means when liquidity remains a big unknown.

A Swiss Pension Plan

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