PensionsEurope survey report on drivers of equity investments by pension funds

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About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries[1].

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents more than **€ 4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **30 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often “not-for-profit” and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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[1] EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.

1. Summary and key messages

- **Pension funds play an important role in the long-term financing of the EU's real economy and contributing to jobs and growth in Europe. Completing the CMU is crucial to boost pension funds' investments in Europe.**
- **Pension funds do not aim to make significant changes to the share of their investments in *public equities* in the upcoming years. Instead, many pension funds are more interested or planning to increase their investments in *private equities*.**
- **Not only is asset class diversification crucial, but geographical diversification is also key to mitigate country or regional risks. The reasons for foreign exposure in investment strategies vary depending on risk tolerance, currency fluctuations, inflation, local market conditions, diversification, and members' preferences.**
- **Many pension funds expect that they will continue investing more in *foreign European equities*, but not (significantly) more in *equities outside Europe*.**
- **There are several reasons why pension funds invest increasingly in foreign equities, and the main drivers are search for yield, reducing volatility, risk diversification, and geographical diversification. Other drivers e.g. include inflation, currency rates, and the supply (availability/access to foreign/international equity asset classes/products/solutions).**
- **Pension funds expect that the share of sustainable investments in their portfolio will continue increasing in the upcoming years.**
- **There is an increasing awareness amongst pension funds that including ESG consideration into asset management may reduce risks and possibly it leads to improved risk-adjusted return in the long-term. There are several reasons why pension funds take longer-term sustainability interests into account in their investments. Besides pension funds are encouraged to do so, many pension funds find that it is particularly important for the globe. Furthermore, several pension funds find that it is important for returns.**
- **Pension funds' investment behavior is expected to remain stabilising and countercyclical, and it is important that legislation continues to allow that. As long-term investors, pension funds are able to mitigate financial shocks and work as stabilising factor for the financial sector.**
- **So far, in many countries (except for instance the UK), Brexit has not had a significant impact on the risk management of pension funds' equity portfolio (except currency risk management).**

2. Introduction

In the summer 2018, PensionsEurope conducted a survey on drivers of equity investments by pension funds. The results of this survey are based on the comments received from 8 countries: Belgium, France, Germany, Italy, the Netherlands, Portugal, Spain, and the UK.

The survey report supplements PensionsEurope comments to the CMU Sub Expert Group on pension funds on the main drivers in cross-border investment by pension funds[2] and PensionsEurope Pension Fund Statistics[3]. We hope and believe our comments are relevant to the upcoming *"study on the drivers of investments in equity by insurers and pension funds"* which DG FISMA has commissioned to Deloitte and CEPS to carry out by the end of 2018.

3. General remarks

Objective of a pension fund and general characteristics

The key objective of a pension fund is delivering good pension outcomes to members and beneficiaries.

- Collective workplace pensions offer:
    - Economies of scale in governance, administration and asset management;
    - Risk pooling and often intergenerational risk-sharing;
    - Often "not-for-profit" and low administrative costs;
    - Sponsoring companies contribute financing to pension funds;
    - Long-term horizon of investments;
    - Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
    - Good governance and alignment of interest due to participation of the main stakeholders.

The main drivers of pension funds' investment strategy

- **Pension funds' investment strategy must balance risk, return and costs.**
- **The main drivers of pension funds' asset allocation include asset and liability management, risk management, hedging against inflation, return on investments, hedging liability risks, and diversification.**
- Pension funds invest in accordance with the 'prudent person' and/or in accordance with national regulatory investment requirements.
- Pension funds (have started to) invest in accordance with scheme members' preferences.
- Pension funds' investment portfolios differ from many other institutional investors due to longer duration of liabilities, often an absence of early termination risks and different legislations. In general, pension funds invest more in private markets and international markets, whereas some other institutional investors more in fixed income.
- In general, pension funds' possibilities to invest in equities are affected by short-term/one-year oriented accounting/funding rules (respectively buffering rules against equity volatility).

[2] You can find the minutes of the 1st meeting of the CMU Sub Expert Group on pension funds here (24 October 2017). In February 2018, the Sub-Group gave its proposals and recommendations to the Expert Group on barriers to free movement of capital in the context of the CMU.

[3] See PensionsEurope Pension Fund Statistics.

Pension funds are important investors in the European economy

- **Pension funds play an important role in the long-term financing of the EU's real economy and contributing to jobs and growth in Europe.**
- The amount of pension funds' assets invested in the European Economic Area (EEA) differs between Member States and ranges from 45% to over 75%.
- Pension funds increase the amount of market-based financing available to the economy and improve the efficiency of financial intermediation.
- **Countries with a substantial funded pension funds sector tend to have better developed capital markets.**
- Many non-euro area investments can also have a positive impact on Europe indirectly, as many companies or part of their European business is financed via capital markets around the world.
- **Growing, developing, and stable economy attracts investments. If investment opportunities in Europe will improve, the stake of the European investments by pension funds will increase accordingly. Implementing the European Commission's CMU action plan would be very helpful in this respect.**

4. The share of pension funds' investments in equities

In general, the share of pension funds' investments in equities varies significantly from country to county in Europe. Depending on (i) the definition of a pension fund, (ii) from where the data originates, and (iii) whether statistics contain data from DB and/or DC schemes, various statistics show different figures. Furthermore, (iv) some statistics contain only pension funds' direct holdings of equities, whereas some others include also their indirect holdings via investment vehicles etc. Below are some examples of the statistics of the share of equity investments by pension funds in various countries[4]:

- 39% in Finland;
- 38% in the Netherlands;
- 38% in France[5];
- 30% in Spain[6]
- 30% in Switzerland;
- 29% in the UK[7] (or more[8]);

[4] See the statistics of the ECB, OECD, and World Bank in the presentation (slide 10) of "Financial integration, capital market development and risk sharing in the euro area" by Mr Philipp Hartmann (Deputy Director, General Research, the ECB) at the event of the Belgian Financial Forum on 14 May 2018.

[5] See the statistics of the French Asset Management Association (AFG) on the PERCO.

[6] 9% in direct investment according to the statistics of the Ministry of Economy and Enterprise in Spain, plus 21% through indirect investment (investment funds with exposure to equity).

[7] See the statistics of the Pension Protection Fund.

[8] See the Thinking Ahead Institute's Global Pension Assets Study 2018 (slide 27).

- 18% in Italy[9];
- 15% in Germany[10];

In many countries, the share of pension funds' investments in equities has increased in recent decades, and the main drivers have been low interest rates, a search for yield, and risk diversification. On the other hand, currently many equities are at all-time high. A notable exception to this trend has been UK defined benefit pension schemes, where equities fell from 52.6% in 2006 to 36.8% in 2016, as schemes are continuing to de-risk.

No significant changes expected to the share of pension funds' investments in equities in the upcoming years

Pension funds do not aim to make significant changes to the share of their investments in *public equities* in the upcoming years. Some pension funds aim to continue increasing equity shares in their portfolios, whereas some others do not expect to make significant changes. Even though the percentage is not expected to significantly increase (certainly it could for individual pension funds), the amount invested in equities is expected to increase in the upcoming years and decades. Pension funds' liabilities will continue to grow, and the assets will do so accordingly.

Instead, **many pension funds are more interested or planning to increase their investments in *private equities*.** The private equity market can provide long-term investments with higher yields in a low interest environment. This makes private equity a suitable candidate for more investments in the upcoming years. At the same time, in some countries (such as the Netherlands) there is discussion e.g. about the risks associated to these investments, and possibly this could lead to declining investments.

In general, the equity exposure depends on the development of pension funds' solvency position (funding ratio). In good times, there is more room for equity investments (also for instance from the perspective of the Dutch supervisory framework nFTK). Supervisors consider increasing equity investments as riskier investment strategy and they encounter higher solvency margins and/or require ex-ante approval to change the risk profile of the investment portfolio.

In the UK, as far as DB pension funds are concerned the share of equity holdings has fallen markedly over the past ten years and it looks that this trend will continue as UK funds look to an end point in 'journey planning' – often buy out. There is also a general trend towards de-risking as pension funds mature. In part this is also driven by many sponsors wanting less volatility in the numbers reported on their balance sheet. Of course, there are exceptions to this rule with some sponsors being keen (perhaps keener than trustees) to search for more return. On the other hand, DC funds will hold equities – probably in greater proportion than DB – through index tracking funds, lifestyle funds and

[9] Average level, as equity investments vary across various types of pension funds. At the end of 2017: closed pension funds 21%, open pension funds 20%, pre-existing pension funds 18%, insurance contracts 10% (see Report for the year 2017 of the Commissione di Vigilanza sui Fondi pensione – Covip).
[10] See the analysis of the German Asset Management Association BVI.

Diversified Growth Funds. Few members are expected to actively 'self-select' funds with significant equity share.

5. Investing in international markets

Geographical diversification

Not only is asset class diversification crucial, but geographical diversification is also key to mitigate country or regional risks. The geographical diversification can lead to increased expected returns and better Sharpe ratio (risk-return).

Traditionally pension funds have focused strongly on their domestic markets (equities and bonds). Nowadays pension funds are investing more and more in international markets and in alternatives. In some countries (such as the Netherlands) this change has taken place already some decades ago.

Motivations for investing in international markets

The reasons for foreign exposure in investment strategies vary depending on risk tolerance and appetite, currency fluctuations, inflation, local market conditions, and diversification. **In general, pension funds invest in international markets to reduce overall portfolio risks and to harvest different risk premiums.** Furthermore, many countries have specific bias in their local stock market (e.g. financials or chemicals), and broadening the countries invested in also decreases sector and specific (company) risks.

Other motivations for investing international markets e.g. contain availability/access to attractive (price, quality, liquidity, transparency) foreign equity products and solutions. Not only the demand side matters, but also the supply side.

In countries with higher currency fluctuations, investments in local market – including the exchange rate converted into the national currency/euro - are volatile. Hence, overseas investments are hedged against currency rate changes. Likewise, high inflation can motivate investments assets abroad.

The EU has made it easier to invest in Europe and to invest across borders within the EU (e.g. UCITS and reporting standardization). Completing the CMU is crucial to boost pension funds' investments in Europe.

Many pension funds expect that they will continue investing more in foreign European equities

Pension funds have various views whether the share of their investments in equities will increase in the upcoming years. **Many pension funds expect that they will continue investing more in *foreign***

***European equities*, and some pension funds expect that share will not significantly increase in their portfolio.**

Many pension funds do not expect that they will continue investing (significantly) more in *equities outside Europe*. On the other hand, it is expected that many countries will continue improving their financial infrastructure and new markets will enter the standard indices. This might cause a shift of pension funds' investments towards these countries (such as China).

A respondent from the UK estimated that possibly there will be a change in proportion of overall equity holdings away from domestic (UK) equities in favour of other European (and ex-Europe) equities, but it is unlikely to be a significant increase in proportion of assets held in equities.

<u>There are several reasons why pension funds invest increasingly in foreign equities</u>

There are several reasons why pension funds invest increasingly in foreign equities, and the main drivers are search for yield, reducing volatility, risk diversification, and geographical diversification. Other drivers e.g. include inflation, currency rates, and the supply (availability/access to foreign/international equity asset classes/products/solutions).

Furthermore, given the fact that the European Market Infrastructure Regulation (EMIR) could make currency hedging more expensive, there could be a tendency to divest from non-euro currencies.

6. Sustainable investments

Global Sustainable Investment Alliance (GSIA) has estimated that sustainable investments now represent around 26% of assets managed globally[11]. However, some of the largest pension funds in Europe are already now investing all their assets in sustainable investments (See for instance IPE 2018 Asset Management guide).

Pension funds expect that the share of sustainable investments in their portfolio will continue increasing in the upcoming years, and there are many reasons for that. In general, ESG (Environmental, Social and Governance) investments are becoming more are more mainstream, and there is an increasing awareness and interest in ESG consideration amongst pension funds and asset managers. Furthermore, national and EU legislations are increasingly encouraging and/or requiring pension funds to consider ESG factors in their investments.

In the UK, recent proposals for legislative change are likely to see (at least) more and better assessment of particular investments against a yardstick of sustainability. Whether this results in 'real' sustainable

[11] See 2016 Global Sustainable Investment Review.

investment or merely greater analysis (and categorization) of what might be considered sustainable remains to be seen.

Where DC schemes are important, and when they offer a choice of investments to their members, the proper design of default options can be key. For example, in France, thanks to a welcomed change in legislation, default options in DC schemes (PERCO and others) will progressively be life cycle funds (and not anymore predominantly money market funds or capital guaranteed insurance contracts) and a positive impact on equity investing should follow suit.

Pension funds have various views about the impact on returns of taking longer-term sustainability interests into account. Many pension funds find that usually it does not make a significant difference in returns. Some respondents find that possibly it leads to lower returns in the short-term, and potentially such short-termism is exacerbated by triennial valuation cycles and short-term journey plan horizons. In general, capital market theory tells us that, if ESG reduces pension funds' investable universe, theoretically it also increases risk (ceteris paribus) because of a lower degree of diversification. Moreover, the reporting requirements and management of ESG financial products is higher than plain vanilla market based financial products.

On the other hand, some pension funds would agree with the following statement of the European Commission Action Plan on Financing Sustainable Growth[12]: *it is important to recognise that taking longer-term sustainability interests into account makes economic sense and does not necessarily lead to lower returns for investors.* **There is an increasing awareness amongst pension funds that including ESG consideration into asset management may reduce risks and possibly it leads to improved risk-adjusted return in the long-term.** Availability of data, insights and track records are quickly increasing. Some respondents find that possibly the highest returns are the non-financial gains associated with long-term sustainable investments, and that taking longer-term sustainability interests into account will impact the realization of returns (and their level) due to better active management decisions.

There are several reasons why pension funds take longer-term sustainability interests into account in their investments. Besides pension funds are encouraged (e.g. by many pension fund members) to take longer-term sustainability into account in their investments, many pension funds find that it is particularly important for the globe. Furthermore, several pension funds find that it is important for returns. As mentioned earlier, the key objective of a pension fund is delivering good pension outcomes to members and beneficiaries, and this requires a long-term investment horizon.

7. Pension funds' investment behavior is stabilising and countercyclical

The respondents do not expect changes to pension funds' stabilizing and countercyclical investment behavior. The main risks to this behavior of pension funds are the growing popularity of low-cost passive investments (although the rebalancing/countercyclical behaviour could very well be

[12] See the European Commission Action Plan on Financing Sustainable Growth.

continued) and the gradual shift towards DC/hybrid schemes instead of DB schemes (although many DC schemes pursue a lifecycle approach implying a countercyclical rebalancing strategy). Furthermore, some respondents found that legislative capital adequacy requirements or accounting rules may drive pension funds away from equities (including long-term sustainable investments) in favour of other investments (including sovereign bonds).

In the 2015 stress test report EIOPA stated that pension funds' investment behaviour was on aggregate and on average counter-cyclical. Two years afterwards in 2017 EIOPA e.g. noted that many pension funds follow a buy-and-hold strategy, and consequently alleviate selling pressure during stressed market conditions.

The results of EIOPA IORP stress tests, PensionsEurope survey, and financial literature[13] confirm pension funds' countercyclical behaviour and their important role in stabilising financial markets. As long-term investors, pension funds are able to mitigate financial shocks and work as stabilising factor for the financial sector. Pension funds' long-term horizon and their ability to follow contrarian investment strategies support the proposition that pension funds can act as shock absorbers in the economy by providing liquidity and by not being forced to sell assets when asset prices are squeezed. The results confirm that the investment strategies of pension funds are very stable, including to a certain extent buy-and-hold-strategies. **It is important that legislation continues to allow pension funds' countercyclical behaviour.**

8. <u>In many countries Brexit has not had a significant impact on the risk management of pension funds' equity portfolio</u>

So far, in many countries (except for instance the UK), Brexit has not had a significant impact on the risk management of pension funds' equity portfolio (except currency risk management), even though some respondents found that an investment risk in the British companies[14] has slightly increased. The overall growth is expected to be hit (by varying degrees dependent on the final negotiated position), but possibly this will not have direct effect on pension funds' risk management. Future impact will depend on the outcome of Brexit negotiations. In the UK, there appears to be a growing interest in managing FX risk specifically, particularly given the increasingly globalized nature of many UK pension scheme portfolios, but this does not yet seem to have resulted in a significant additional level of currency hedging.

PensionsEurope has e.g. stressed[15] that pension funds would like to see Brexit negotiations concluded in a manner that provides stability, in economic terms and impact on investment markets. This is needed to allow pension schemes to invest in a manner that enables them to have confidence that they will be able to pay out the benefits to members of schemes. In order to do this, it is important

[13] See also the Working Paper of Mefop n. 40 on Investment Strategies of Italian Pension Funds: contrarian or momentum?

[14] It is worth of noting that many companies listed on the London Stock Exchange are not British companies.

[15] See PensionsEurope Position Paper on Brexit (March 2018).

that the negotiations are concluded with an agreement. Such an agreement would provide stability to the economy and investment markets. It would be good for the benefits of the employees, the employers who sponsor pension schemes and for the investments made by those schemes.