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Investment Institute *Macroeconomics*

Pensions investment outlook 2023: New realities, big decisions

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Key points

- Pension schemes must adapt to stark changes in economic conditions, with current sustained high inflation and recessions on the horizon
- Rising prices have exposed a lack of inflation protection among some schemes, both DB and DC, and there are limits to how they might respond
- We expect schemes to continue pushing the integration of sustainability factors in portfolios, driven by regulatory imperatives and an expanding opportunity set
- Turmoil in UK markets in autumn 2022 has focused attention on liquidity, with schemes expected to pursue a general fall in leverage
- There may also be a desire to reduce weightings to illiquid assets with many schemes now breaching internal ceilings for maximum exposure
- The rising interest rates environment will likely drive allocations to selected investment-grade debt assets. Supranational, sub-sovereign and agency bonds may be a viable option

Four drivers for 2023 asset allocation

Pension fund investors have ridden a roller coaster over the past two years. After a strong 2021 with exceptional returns, 2022 went in the opposite direction with record losses on sovereign bonds and a major correction in equity markets. The underlying causes will have spillover effects in 2023, and recessions are looming. In this environment, we see four trends that will define the pension fund asset allocation decisions: Ongoing efforts to invest more sustainably; the response to raised and sustained inflation; the need for more liquidity; and the normalisation of interest rate levels.

Since the Paris Agreement on climate change in 2015, pension funds have accelerated their shift toward assets that may be aligned with net zero emissions. The number of portfolios that integrate environmental, social and governance (ESG) factors has significantly increased and we have seen particular interest in impact portfolios that use the UN Sustainable Development Goals (SDGs) to target direct positive effects alongside financial returns. One estimate puts current global impact assets under management at more than $1trn.[1] Within this sector we have seen attention particularly fall on portfolios with an orientation towards biodiversity and clean energy.

The COVID-19 pandemic and the energy crisis in Europe sparked by Russia's invasion of Ukraine, meanwhile, have pushed long-term investors to consider more closely than ever how our economic development is vulnerable to social and environmental factors. And in the European Union (EU), the

[1] GIINsight: Sizing the Impact Investing Market 2022, The Global Impact Investing Network, October 2022

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introduction of a new regulatory framework has required the classification of investment portfolios.[2]

Active for sustainability

We have found that most pension funds are aiming to focus on 'Article 8' – the second most stringent under EU classifications – for their total portfolio. We expect this to continue and drive asset managers to improve the sustainability profile of portfolios they manage for these clients. This would cause a shift away from 'Article 6' funds – those with only minimal consideration of ESG factors. Within AXA IM, some 87% of eligible funds and strategies within equities, fixed income and multi-asset are now classified as Article 8 or Article 9.[3]

Another way of implementing sustainable portfolios for pension funds is to define a sustainable universe, with the purpose to act as a benchmark, from which an active manager can select securities with the goal of outperforming the benchmark. We strongly believe that active managers are better equipped and positioned to implement strategies that target pension schemes' ESG or SDG goals. Active managers should also be better equipped than passive managers, in our view, to report on ESG goals such as carbon intensity, the percentage of women or independent directors on boards and on the eligible green share of revenues. Active managers can carry out qualitative assessments that may enhance a quantitative sustainability assessment.

A new paradigm for inflation

The stickiness of inflation has been an enduring theme for pension fund investors. They have been grappling with it since energy prices started rising in 2021, followed by the supply shock in gas deliveries from Russia linked to the invasion. This rise in energy and commodity prices has worked its way into other goods and services prices throughout 2022. In several countries, pension funds, and therefore their participants, are not very well protected against inflation - this is true for both defined benefit (DB) and defined contribution (DC) schemes.[4] The background to this had been a prolonged period of very low inflation, between zero and 2% in general, which had served to diminish concern about inflation risks. It will take a while before we are back into the 0%-2% territory.

A significant portion of return-seeking assets is the usual defence against inflation over a longer investment horizon but DB funds might not have sufficient room to increase their allocations. DC funds might be able to add more to equities next year, rebalancing their portfolios but that is not without its own risks. With recessions looming, valuations could well come down first before equities recover.

In the meantime, we have seen that pension funds have been looking to add inflation-linked bonds. It is not a guarantee that inflation will come down rapidly if recessions do evolve. A supply-side shock like the Russian gas and oil ban takes more time to get resolved. Energy alternatives are not immediately in place at the low prices we were used to. It takes time, for example, to build liquefied natural gas terminals or wind and solar facilities.

Schemes that have an interest rate hedge in place might be postponing further increases or even diminishing the hedge level as they expect higher inflation will drive interest rates higher next year. With many considering that inflation may be at or near peak levels, funds may be looking for asset classes that could gain from a slowing of inflation. Historically, equities would benefit from such a decline in prices, as might long-dated bonds but also high-yielding bonds and credits.

A warning from the UK

When considering the need for liquidity, pension funds must consider various things. First, there is the ongoing need to be able to pay liabilities such as pension payments and commitments made to real estate and private equity or debt funds. Second, for those funds that have an interest rate hedging overlay in place, in combination with a currency hedge, they have an increasing need for collateral cash when interest rates are rising. As the recent market turmoil in the UK showed, there is a limit to the degree of leverage funds are able to take on.[5] The sudden and extreme shock in government bond yields, in combination with the decline in sterling, caused a squeeze in available collateral. At these times like this, pension funds should be able rely on the repurchase (repo) market, but at what price is the question, if they can access it at all.[6] This experience has made pension funds, both inside and outside the UK, revisit their liquidity 'waterfall' and we expect a general reduction in leverage.

Third, illiquid assets have become significantly overweighted in portfolios after a great 2021 and the sell-off in bonds and listed equity this year. For many schemes, the internal ceiling of the preferred maximum exposure to illiquid assets has been broken. A rebound in liquid assets, mainly equity, is needed to create room again for future new allocations. It is expected that

[2] What is SFDR?, AXA IM, 2022
[3] Source: AXA IM, September 2022
[4] Defined benefit schemes pay members a pension based on their final salary. Defined contribution schemes pay out based on investment returns from payments made by members.
[5] Gilt trip: Lessons for institutional credit investors from a UK liquidity crisis, AXA IM, October 2022
[6] Repo is short for repurchase agreement and normally refers to short-term, often overnight, borrowing.

for private equity and real estate, valuations in 2023 will be revised downwards, which will help as well to rebalance the allocation to illiquid assets.

Rising rates

After decades of declining interest rates and the search for yield over the last couple of years, a fourth trend is emerging: The normalisation of the level of interest rates. Although the fast rebound of yields in 2022 was not expected, we think the current level of interest rates may give investors more opportunities to reallocate their fixed income portfolios.

Sovereign bonds can give a decent yield and, equally important, offer a diversification option versus equities in the future. Investment-grade credits deliver a better yield pick-up, after the spread widening in 2022. These more appealing yield levels in combination with the search for liquidity and the lower ability for DB plans to increase the allocation to alternative illiquid fixed income categories, may bring investors back to the investment-grade asset classes, in our view. Among these are supranational, sub-sovereign and agency (SSA) bonds which have seen more interest as they can potentially give a decent yield pick up over sovereign bonds, especially German.[7] They also serve as High Quality Liquid Assets, important to raise cash on the repo market, being used as collateral assets.[8]

DC schemes will still have opportunities to invest in alternative debt, once their risk profiles can bear it. Looking at emerging markets, from a sustainability angle, funds are discussing the potential need to have Chinese government bonds and state-owned enterprises in their portfolios. Should they be excluded or not? Local emerging market debt has been delivering disappointing results, mainly due to losses on their local currencies versus the euro and funds might reconsider to change back to hard currency emerging market debt. The hoped-for extra return and diversification did not necessarily pay out over the last decade.

It is a complicated backdrop for schemes. The ongoing efforts to invest more sustainably, the response to the raised and longer lasting inflation, the need for more liquidity and the new reality for interest rates will all have an impact on the rebalancing of asset allocation for pension funds in 2023. We believe liquid assets will be in favour versus alternatives. Investment-grade bonds, with their more attractive yields, are an alternative to private debt once more and listed equities have the potential to rebound over the course of the year.

[7] SSA bonds: A sustainable route to institutional portfolio diversification? AXA IM, November 2022

[8] HQLA are defined by the Bank for International Settlements as assets that can be easily and immediately converted into cash at little or no loss of value.

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