Pensions investment outlook 2023: New realities, big decisions

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Pension fund investors have endured a roller coaster two years. After a strong 2021, 2022 saw record losses on sovereign bonds and a major correction in equities. Now, recessions are looming. In this environment, we see four trends that should define 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 rates.

Active for sustainability

Since the 2015 Paris Agreement, pension funds have accelerated their shift toward net-zero-aligned assets. We have seen interest in impact portfolios that use the UN Sustainable Development Goals (SDGs) to target positive effects alongside financial returns. Portfolios with an orientation towards biodiversity and clean energy have also attracted particular attention.

Meanwhile, COVID-19 and the energy crisis sparked by war in Ukraine have pushed long-term investors to consider more closely how our economic development is vulnerable to social and environmental factors. And in the European Union (EU), the introduction of a new regulatory framework has required the classification of investment portfolios.[1]

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. Within AXA IM, some 87% of eligible funds and strategies within equities, fixed income and multi-asset are now classified as Article 8 or better.[2]

We strongly believe that active managers are better equipped and positioned to implement strategies which target pension schemes' ESG or SDG goals. Active managers using qualitative and quantitative tools in combination should also be better equipped than passive managers, in our view, to report on ESG goals such as carbon intensity or gender balance.

A new paradigm for inflation

The stickiness of inflation has been an enduring theme. Schemes have been grappling with it since energy prices started rising in 2021 and rising energy and commodity prices have worked their way into other goods and services through 2022. In several countries, pension funds are not very well protected against inflation – this is true for both defined benefit (DB) and defined contribution (DC) schemes. A prolonged period of very low inflation served to diminish concern about the risks, but it will take a while before we are back into the 0%-2% territory.

A significant portion of return-seeking assets is the usual longer-term defence against inflation, but DB funds might not have sufficient room to increase 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 pension funds looking to add inflation-linked bonds.

It is not a guarantee that inflation will come down rapidly if recessions do emerge – a supply-side shock like the Russian gas and oil ban takes time to resolve and 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.

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 rates higher next year. With many thinking inflation may be at, or near peak, funds may seek asset classes that could gain from its slowing. Historically, equities would likely benefit, as might long-dated bonds but also high-yielding bonds and credits.

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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 rates are rising.

Recent market turmoil in the UK highlighted the limits of leverage.[3] The sudden and extreme shock in government bond yields, in combination with the decline in sterling, caused a squeeze in available collateral. At times like this, pension funds should be able rely on the repurchase (repo) market, but at what price – if they can access it at all?[4] This experience has made pension funds revisit their liquidity 'waterfall' and we expect a general reduction in leverage.

Third, illiquid assets have become significantly overweighted in portfolios after a strong 2021 and after the sell-off in bonds and listed equity in 2022. For many, the internal ceiling of preferred maximum exposure has been broken. A rebound in liquid assets, mainly equity, is needed to create room again for future new allocations. It is expected that for private equity and real estate, valuations in 2023 will be revised downwards, which would help to rebalance allocations.

Rising rates

After a period of declining interest rates and the 'search for yield', we are now seeing a normalisation of interest rates. Although the fast rebound of yields in 2022 was not expected, we think the current level of rates may give investors more opportunities to reallocate fixed income portfolios.

Sovereign bonds can give a decent yield and may offer a diversification option versus equities. Investment-grade credits deliver a better yield pick-up, after the spread widening in 2022. This, in combination with the search for liquidity, may bring investors back to investment-grade asset classes, in our view. Among these are supranational, sub-sovereign and agency (SSA) bonds which can give a decent yield pick up over sovereign bonds, especially German.[5] They also serve as High Quality Liquid Assets, important to raise cash on the repo market, being used as collateral assets.[6] DC schemes will still have opportunities to invest in alternative debt, once their risk profiles can bear it.

It is a complicated backdrop. All the factors we have discussed will 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 year.

FOOTNOTE

1 What is SFDR?, AXA IM, 2022
2 Source: AXA IM, September 2022
3 Gilt trip: Lessons for institutional credit investors from a UK liquidity crisis, AXA IM, October 2022
4 Repo is short for repurchase agreement and normally refers to short-term, often overnight, borrowing.
5 SSA bonds: A sustainable route to institutional portfolio diversification? AXA IM, November 2022
6 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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