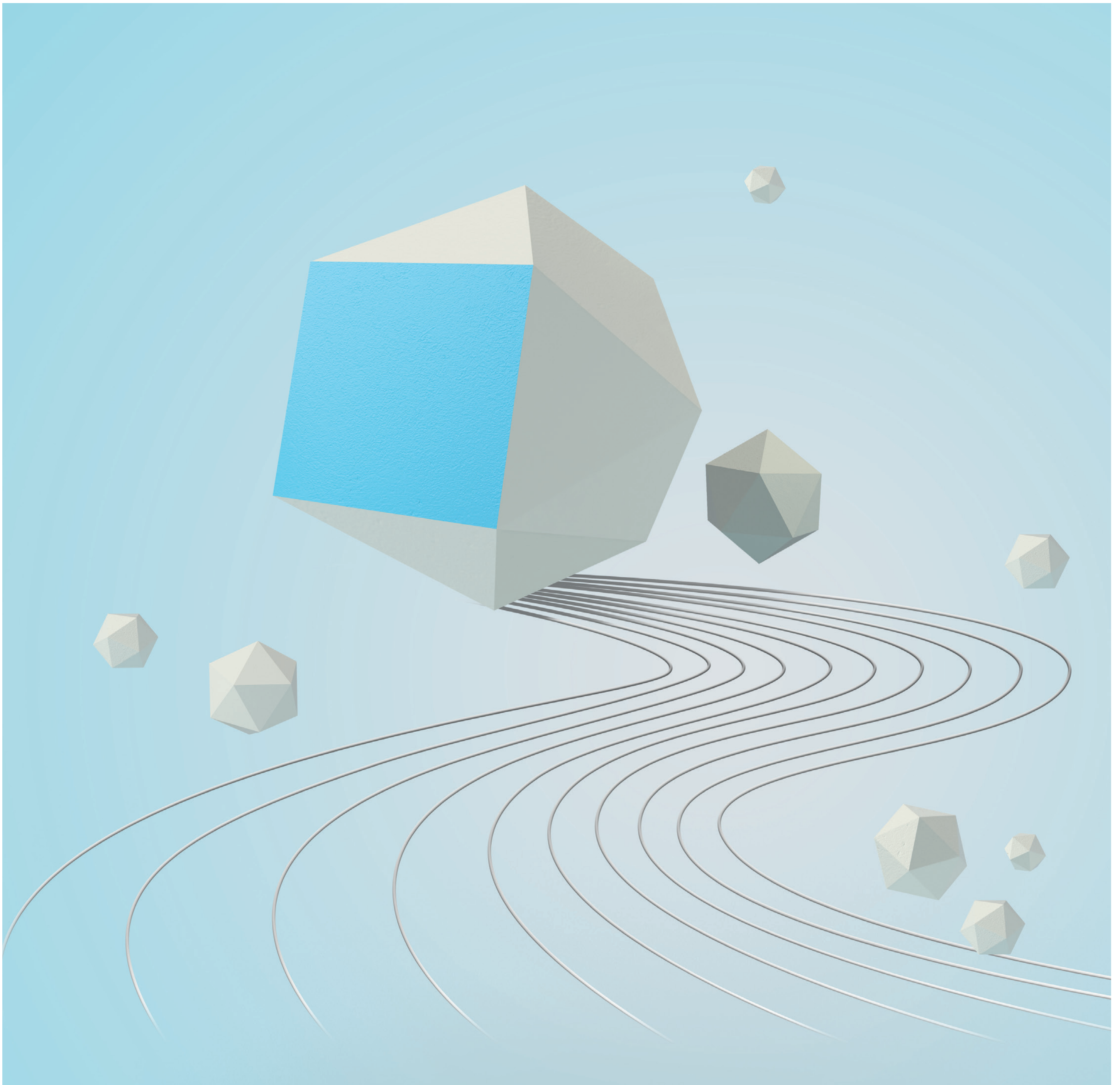


Quantitative easing: the end of the road for pension investors?

Author: Prof. Amin Rajan

create

Amundi
ASSET MANAGEMENT

Author: Prof. Amin Rajan

First published in 2019 by:
CREATE-Research
Grosvenor Lodge
72 Grosvenor Road
Tunbridge Wells
Kent TN1 2AZ
United Kingdom

Telephone: +44 (0)1892 784 846
Email: amin.rajan@create-research.co.uk

© CREATE Limited, 2019.
All rights reserved. This report may not be lent, hired out or otherwise disposed of by way of trade in any form, binding or cover other than in which it is published, without prior consent of the author.

Foreword

The 2019 edition of the Amundi–CREATE Research survey provides a key independent assessment of the challenges faced by pension plans in a post-QE environment.

So severe was the 2008 global financial crisis that central banks could only stave off a worldwide depression with a huge unconventional monetary stimulus. The worst was avoided and the global economy started to recover. Financial markets have enjoyed their longest bull run in history.

Yet, ten years later, recovery remains tepid: the global economy has yet to cut loose from its deflationary mindset. Both the US Federal Reserve and the European Central Bank have been forced to embark on yet another round of monetary stimulus.

This time round, however, investors are not jumping for joy. The reason is that central banks' policies so far have created a number of unintended consequences for them, such as lower yields for longer and inflated asset prices.

Hence, as we enter a new era of monetary policy, it is timely to do a stock-take on what effect such policies have had on pension plans so far. That is what this survey seeks to do.

It highlights how pension investors have been adapting to a radically new financial environment by changing their asset allocation approaches and their business models.

Liquidity management has become paramount to managing risks as volatility rises. Pension funds seek risk factor based diversification, secular themes, defensive equities for yield generation, illiquid assets for both returns and reduced mark-to-market risk, and emerging markets assets for long-term growth dynamics.

This advocates for partnerships between pension plans and asset managers able to provide a complete suite of capabilities, built on trust, alignment of interests, mutual understanding and tailored services in order to better face the uncertain times ahead and beyond.

Amundi Asset Management thanks Amin Rajan for this insightful and useful report. We hope you will enjoy reading it.

Pascal Blanqué

Group Chief Investment Officer
Amundi Asset Management

Acknowledgements

In this decade, central banks' unconventional monetary policies have been an overarching influence on the financial viability of pension plans.

This survey is the latest in the annual Amundi–CREATE series started in 2014. It presents the most detailed assessment available so far on how such policies have affected pension plans' finances, their asset allocation and their business models.

My foremost thanks go to 153 pension plans and 38 pension consultants who participated in the two separate surveys on which this report is based. They have provided rich insights into the changes brought about by a big disconnect between financial markets and the real economy.

Their regular participation in this series has helped to create an impartial research platform that is widely used in all pension jurisdictions worldwide.

My special 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 over the years to burnish the thought leadership credentials of the series.

I would also like to record deep appreciation to IPE for carrying out the surveys in this series, and especially its editor, Liam Kennedy, for inspiration and encouragement over the years.

Finally, I want to express deep gratitude to three immediate colleagues: Lisa Terrett for managing the survey and data analysis; Anna Godden for managing the deskwork and interview programme; and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors and omission in this report, I am solely responsible.

Amin Rajan

Project Leader
CREATE-Research

Contents

Foreword i

Acknowledgements ii

1 — Executive summary 1

Introduction and aims 2
Survey highlights 3
Headline findings 4
Theme 1: Japan may be a case study for problems facing the West 7
Theme 2: The global economy is poised on a knife edge between deflation and inflation 8
Theme 3: Pension plans will be entering the next recession with weaker finances 9
Theme 4: Back to basics is the new mantra 10

2 — Quantitative easing in action: 11
What is the scorecard so far?

Overview 12
QE has worked but mostly as a crisis-era measure 13
QE is caught in a debt trap of its own making 15

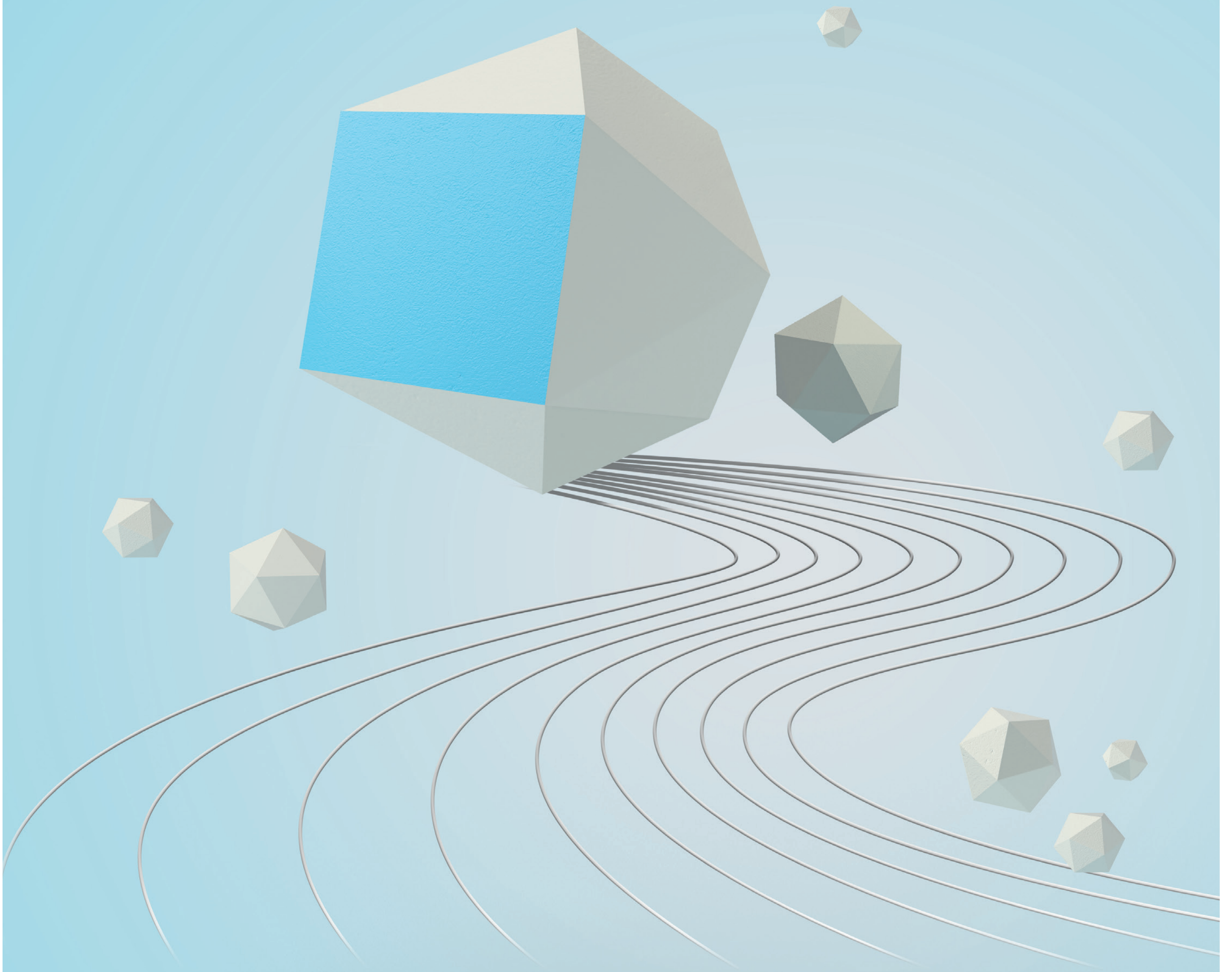
3 — Asset allocation in an era of QE: 17
What are the key imperatives?

Overview 18
Capital conservation is vital in a late-stage cycle 19
There is a limit to how high today's asset valuations can go 21
Reducing mark-to-market volatility will be a key aim 23

4 — Business models: 25
What does savvy portfolio execution mean?

Overview 26
Better returns require minimal implementation leakage 27
Alignment of interests is the new silver bullet 29

1 Executive summary



Introduction and aims

"What goes up must come down."

Isaac Newton

Has central banks' Quantitative Easing (QE) been a blessing or a curse for investors?

After averting a 1929-style global depression in the wake of the Lehman collapse in 2008, central banks in key economies have faced the Herculean task of unwinding their crisis-era emergency measures, involving zero-bound interest rates and large-scale asset purchases.

10 years on, advanced economies have continued to operate below their natural speed limits. QE has reached the point of diminishing returns, while denting the credibility of its principal architects.

In June 2017, former US Federal Reserve Chair Janet Yellen mused that quantitative tightening in terms of balance sheet normalisation would be like "watching paint dry".

Yet, while the paint was still drying, the Fed was back in panic mode in January 2019, after the stock markets' cardiac arrest in late 2018 was blamed on the Fed's rising rates and shrinking balance sheet.

The Fed duly performed a sharp U-turn barely a month after Chairman Jerome Powell had proclaimed that quantitative tightening "was on autopilot".

The Fed's rate-hiking cycle has now been reversed, as recessionary red flags flutter in the global economy. The European Central Bank has followed suit.

A new era of QE beckons.

It is time, therefore, to perform a stocktake on the effect QE has had on pension plans so far and how their asset allocation approaches are likely to change as QE evolves into its next round.

This report covers three questions:

- what has been the impact of previous rounds of QE on the financial viability of pension plans?
- where can they find decent returns in this new era of policy reversal?
- what business model changes will become essential in the process?

These questions were pursued in two separate pan-European surveys.

The primary one covered 153 pension plans; the secondary one covered 38 pension consultants. This report focuses on the first one and uses the second one to validate the key data points.

Pensions plans participating in the first survey had €1.88tn in assets under management. Their background details are given in the figure below.

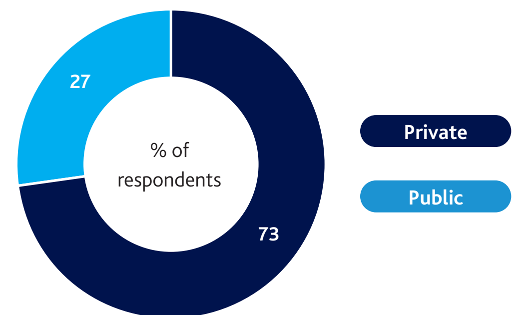
Those in the second survey had €1.4tn in assets under advisement. Data from both sets are appropriately labelled in this report.

The survey results were bolstered by structured interviews with 30 senior executives from the two groups to obtain deeper insights and foresights.

The rest of this section presents the survey highlights, their three headline findings and the four themes that support them.

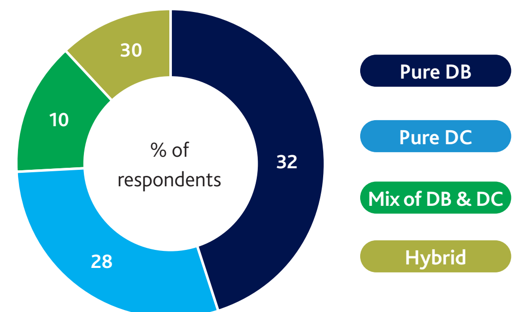
Pension plan respondents

What sector does your pension plan cover?



Source: Amundi Asset Management/CREATE-Research Survey 2019

What is the nature of your plan?



Source: Amundi Asset Management/CREATE-Research Survey 2019

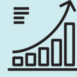
Survey highlights

(% of pension plan respondents)

Positives

67%

QE has stabilised financial markets after the Lehman collapse

58% 

QE has delivered good returns on riskier assets in this decade

50%

QE has eased financing by governments, companies and households

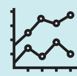
36%

QE has kick-started growth in the global economy after the collapse

Negatives

78%

QE has inexorably inflated global debt and sown the seeds of the next crisis

62% 

QE has overinflated pension liabilities via zero-bound interest rates

51%

QE has given governments an excuse to backslide on growth-friendly supply-side reforms

50%

QE has undermined the longer-term financial viability of pension plans

Asset allocation

62%

Rely on liquidity management to manage market risks as volatility rises

61%

Rely on risk-factor diversification to preserve and grow their capital

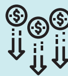
55%

Follow secular investment themes to pursue selective growth points in the global economy

51%

Will continue to rely on illiquid assets to reduce mark-to-market volatility in their asset allocation

Business model

66% 

Rely on cost reduction to bridge the gap between expected and actual returns

63%

Prefer asset managers who offer a strong alignment of interests: financial and nonfinancial

59%

Have strengthened the investment expertise of their trustee boards to improve strategic asset allocation

46%

Prefer asset managers with deep expertise in liquidity management

Headline findings

1. The problems that brought about QE cannot be resolved by QE

As a crisis-era measure, QE has worked. But its unintended side effects have undermined its overall effectiveness.

On the plus side, it stabilised financial markets roiled by the severe 2008 credit crisis. It delivered good returns on riskier financial assets. It eased financing by governments, companies and households, as liquidity dried up. It gave governments time to tackle the deep-seated causes of the crisis. Above all, it kick-started growth in a global economy caught in a downward spiral.

It will be very hard to unravel QE without huge market volatility – so deeply entrenched is it now in investor psyche after ten years of ultra-loose money.

On the minus side, it allowed global debt to rise inexorably and sow the seeds of the next crisis. It disconnected asset prices from their intrinsic value. It gave governments an excuse to backslide on essential growth-friendly supply-side reforms. It overinflated pension liabilities via zero-bound interest rates.

Overall, QE has destabilised the finances of pension plans (Figure 1.1).

QE is now at the point of diminishing returns in Japan (cited by 75% of respondents), the eurozone (64%), the USA (57%) and the UK (52%); as shown later under Theme 1.

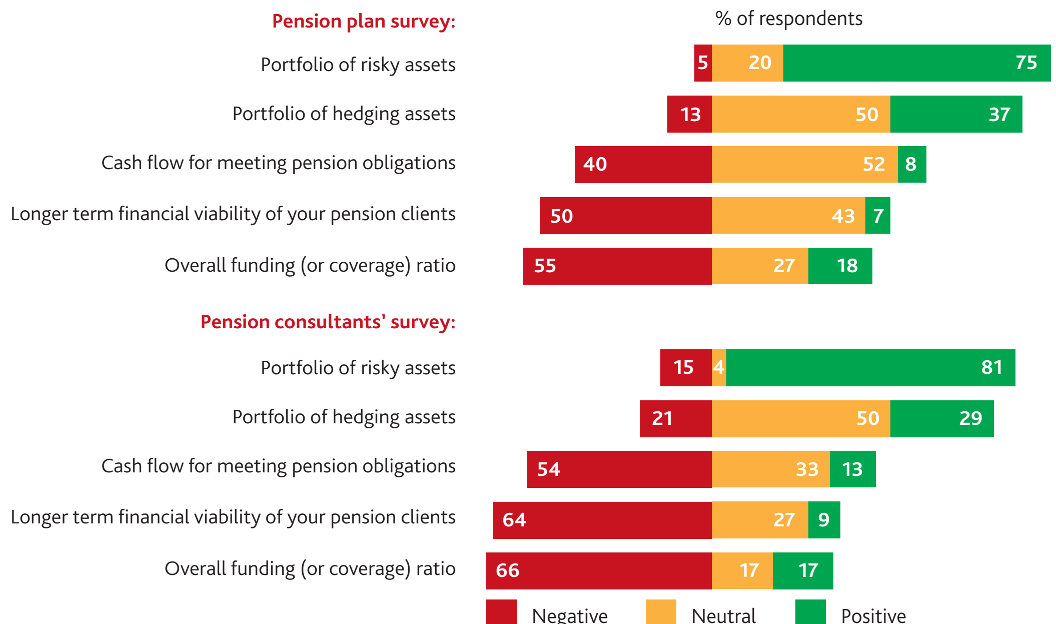
As the US Federal Reserve and the European Central Bank now reverse their quantitative tightening policies in the face of mounting recessionary worries, Japan provides a disturbing glimpse of the future. Since 1995, it has had nine rounds of QE without reigniting growth and inflation in the real economy.

There and elsewhere, QE has worsened income and wealth inequalities by putting a rocket under asset prices without pushing growth back to its trend line. It hasn't perceptibly tackled deep-seated structural problems such as ageing demographics, stagnant productivity, and slowing innovation.

Governments have yet to address them, after their deficits hit record highs in the wake of the crisis. This may well have contributed, among other things, to the rise of populism.

When asked about QE's future, the majority of our survey respondents think that it will be very hard to unravel QE without huge market volatility – so deeply is it now entrenched in investor psyche after ten years of ultra-loose money.

Figure 1.1 What has the net impact of quantitative easing been on various aspects of pension finances?



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"Problems in Europe and Japan are structural. QE can't fix them. It can only act like an anaesthetic before surgery."

"Financial imbalances have built up as markets have hit fresh highs with convictionless trades."

The global inflation dragon is merely a sleeping giant, not a slain beast; if the history of debt monetisation is any guide.

A minority even anticipate that we may see a doubling down via the adoption of *Modern Monetary Theory*. To them, *QE 1.0* helped the rich via asset inflation. The recent rise of populism means that there will be *QE 2.0* to help the poor via massive fiscal stimulus to be funded by central bank money printing. The global inflation dragon is merely a sleeping giant, not a slain beast, if the history of debt monetisation is any guide. Initially meant as a temporary crisis-era measure, QE has acquired a life of its own, inflating the global pile of negative interest bonds to a record $17tn – a quarter of all fixed income assets.

Debt crises tend not to have a good ending, on past form.

(Themes 1 and 2 provide more details: pp. 7-8)

2. 'Back to basics' now describes asset allocation

Pension plans expect to go into the next recession with their finances weaker than ever. Hence, their current aims are to conserve capital, manage liquidity, plan for mean reversion and reduce mark-to-market volatility. They are investing in a range of quality public and private market assets, and increasing their holding periods to avoid the episodic dearth of liquidity (Figure 1.2). Their asset choices reflect four prospective investment themes.

First, quality equities will remain a favoured defensive play, offering good yield and total return, as plans advance into negative cash flow territory due to ageing membership. Ironically, an asset class once perceived as risky has become a safe haven in today's distorted markets.

Second, the structural shift towards uncorrelated private market assets will continue, so as to earn good returns and reduce mark-to-market volatility: the bane of public markets. Much of their current all-time high 'dry powder' – uninvested capital – is lying in wait for the next big market dislocation.

Third, emerging market assets are seen as an ideal vehicle for riding a secular wave that capitalises on selective growth points in the global economy, while the fear of secular stagnation persists.

Finally, bonds are not seen so favourably, given the compressed credit curve and tighter spreads. Credit is believed to be mispriced while much capital remains misallocated. The prospect of continuing subdued inflation will likely keep sovereign yields lower than they have been over the past 30 years.

(Theme 3 provides more details: p.9)

Figure 1.2 **Which asset classes will be most popular while quantitative easing lasts?**

Top 10 choices

Pension plans	% of respondents
Global equities	58
Infrastructure	51
Real estate	46
Alternative credit	44
US equities	44
Private equity	42
European equities	40
EM equities	38
EM government bonds	36
EM investment grade corporate bonds	33

Pension consultants	% of respondents
Infrastructure	54
Alternative credit	50
Global equities	50
Real estate	42
EM equities	40
European equities	39
Private equity	35
EM government bonds	35
US equities	33
High yield bonds	31

Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"We're in the midst of a Fed-induced bubble. That script never has a good ending. But you have to ride the wave."

"Will the 35-year bull market in bonds come to an end? Yes, perhaps, or maybe not."

3. Asset prices are expected to revert to their mean

That QE is losing its potency is further indicated by the fact that our survey respondents expect valuations to revert to their mean (Figure 1.3).

At the outset, investors ventured up the risk curve via convictionless trades in the belief that QE had set a floor under asset prices and dampened their volatility. The 'buy the dips' mentality was all too evident. Each fall was a buying opportunity in what was dubbed a TINA market: there is no alternative.

Such herding was reinforced over time as central banks upped the ante, when growth and inflation did not take off as expected. The resulting financial imbalances are now glaringly obvious, as is the implied misallocation of capital.

What pension plans themselves do matters a lot in influencing ultimate investment returns.

The yield curves in all key economies are already flashing red. Recent tit-for-tat tariff wars and beggar-thy-neighbour currency wars might well make it hard to mobilise an internationally coordinated response when the next crisis comes. So, the prevailing investor narrative seems to be reversing: from "bad news for the economy is good news for risky assets" to "bad news for the economy may soon be bad news for risky assets".

There is an expectation that notions of risk premium, time premium, fair value and mean reversion will kick in before long.

(Theme 4 provides more details: p. 10)

4. Minimising implementation leakage is a key priority

Savvy portfolio execution is now seen as the new silver bullet. Experience shows that there is often a gap between *ex ante* promises and *ex post* returns – owing to untoward factors.

To bridge the gap, portfolio costs are being reduced via a switch towards passive funds and the adoption of meritocratic incentives for active funds.

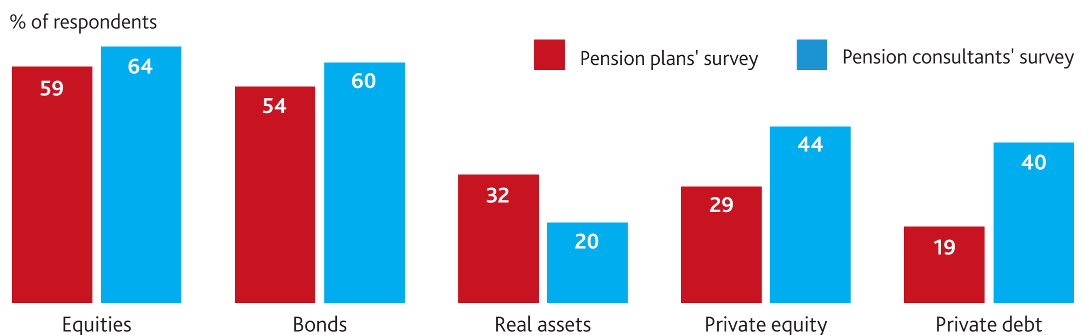
Additionally, investment expertise on trustee boards is being enhanced; as is the talent pool of in-house professional staff. This, in the belief that what pension plans themselves do matters a lot in influencing ultimate investment returns. The aim is to seek prime mover advantage, improve manager selection and enhance capabilities in private markets.

In the process, the spotlight has turned on alignment of interest with external asset managers with two aims: to have an equitable sharing of gain and pain financially; and to have common investment beliefs and time horizons to avoid the two most silent of portfolio killers: 'wrong time' risk and 'regret' risk.

With QE reaching the point of diminishing returns, the old investment maxim is resurfacing: understand what you buy and buy what you understand.

(Theme 4 provides more details: p.10)

Figure 1.3 **Over the next 3 years, which of the broad asset classes, if any, will see their current valuations reconnect with their fundamentals after being distorted by quantitative easing?**



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"Stocks of quality companies gain more by losing less. And outperform over full cycles."

"Asset prices will discover that they have a reverse gear, as cycles always prevail eventually. Trees don't grow to the sky."

Theme 1 Japan may be a case study for problems facing the West

That QE has delivered many benefits is not in doubt. Reportedly, some 50% of global growth in this decade is directly or indirectly attributed to it, as lower rates have enabled households and firms to bring forward their future spending. Some 60% of the rise in asset prices is also attributed to it; as it drove investors into risky assets.

Now there are strong concerns that QE is running out of steam in all the key regions where it has been undertaken since the crisis: it is highest in Japan and at varying degrees in other regions (Figure 1.4).

Now there are strong concerns that QE is running out of steam.

Japan first cut its interest rate to 0.5% back in 1995 and since then has had nine rounds of QE, including large-scale unprecedented purchases of equity ETFs lately, without rekindling growth and inflation. These have merely weakened the yen, boosted property and stock prices, and turned the Bank of Japan into one of the largest shareholders in Japanese companies. Mounting worries about what the future holds for both job and business security has restrained household and business spending.

Fears about the impending recession are stalking the markets. But many pension plans are just as worried about the geographical spread of a deeper structural shift dubbed 'Japanification': ageing population, stagnant productivity, rising government deficits and extreme debt monetisation; all conspiring to drag down productive potential.

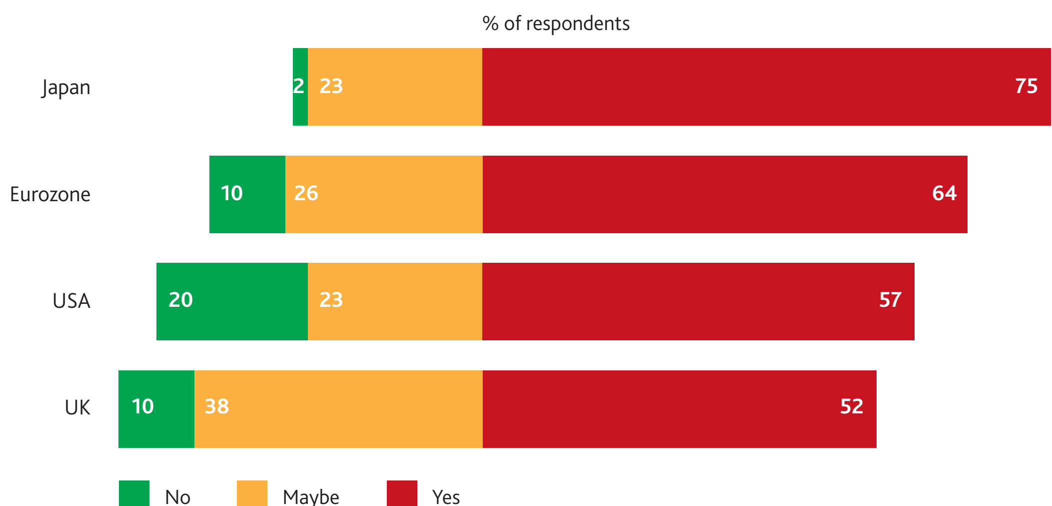
In other regions, while the majority of our respondents believe that QE has reached the point of diminishing returns, a significant minority either remain unsure or think otherwise (Figure 1.4).

Yet, the backlash against QE is no less real. Many respondents believe that it has been a big factor in the recent rise of populism by favouring the rich via asset price inflation, while failing to spark inflation in the real economy due to the rise of globalisation since the 1980s.

Globalisation has generated net gains worldwide but concealed the resulting inequalities in developed countries by claiming many semi-skilled jobs via offshoring as well as wage stagnation.

The process has also ensured that today's sources of inflation are no longer confined to the domestic economy – as in the past. This has undermined the ability of central banks to control inflation – at least for now.

Figure 1.4 **Do you think quantitative easing has reached the point of diminishing returns in the key regions where it was introduced in this decade?** (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"After over twenty years of QE, Japan remains mired in economic torpor."

"What were once QE's strengths have now turned into weaknesses."

Theme 2 The global economy is poised on a knife edge between deflation and inflation

Desperate times may call for desperate measures.

Despite a decade of QE, key economies in the West have not achieved escape velocity: the speed needed to break free from a gravitational deflationary force without further propulsion.

With budget deficits now at record levels, their governments have been unable to address deep-seated problems in the real economy.

QE was not designed to tackle them head on via unorthodox monetary means; but rather to give governments time to solve them via fiscal, education, training and innovation policies.

Unless governments up the ante, therefore, the global economy may be trapped in a QE-forever cycle (Figure 1.5).

Only around 15% of pension plans and 20% of pension consultants believe that QE's withdrawal in the future will be an orderly process with periodic volatility.

In contrast, over half of our respondents believe that QE will be very hard to unravel without huge market volatility.

A significant minority of pension plans, 33%, even see QE embracing *Modern Monetary Theory* over time.

It advocates massive budget deficits to bring about structural changes, to be funded mostly by central bank money printing. Its rationale is simple: since QE 1.0 helped the rich get richer via asset price inflation, it's time for QE 2.0 to help the poor become less poor, in an age defined by raging inequalities.

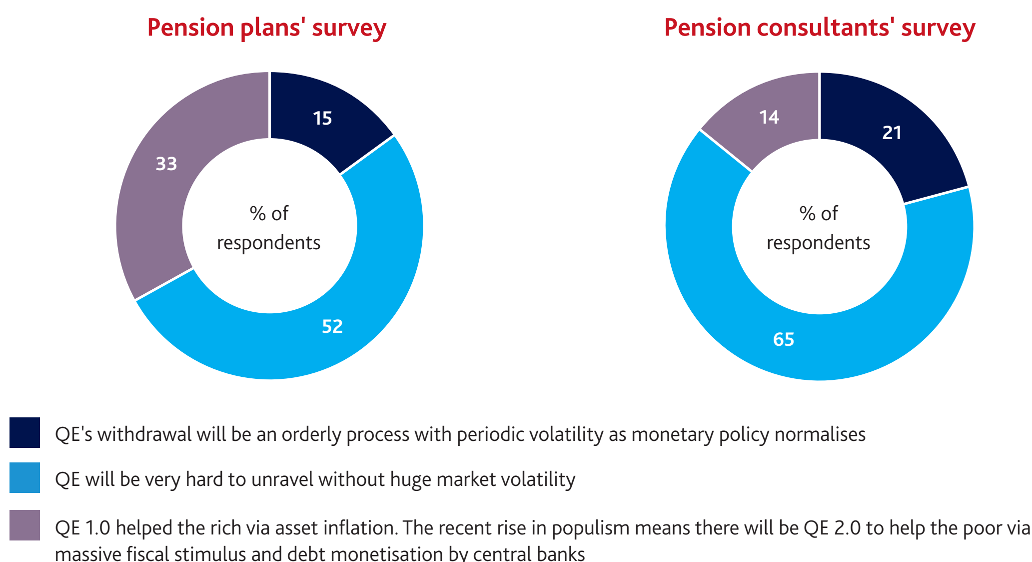
Similar policies have stoked hyperinflation in many Latin American countries in recent years and in the developed world in the 1970s.

Today, there is a clear trade-off between inflation and inequalities. The rise of populism is tilting the scales towards the latter.

This is especially evident with the 'Green New Deal' promised by the Democratic Party in the US and 'People's QE' by the Labour Party in the UK.

Desperate times may call for desperate measures.

Figure 1.5 **Looking ahead, which of the following statements best describes your views about the future of quantitative easing?**



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"Previous rounds of QE were for Wall Street. The next one will be for Main Street."

"The global debt python will continue to constrict growth as its service cost climbs."

Theme 3 Pension plans will be entering the next recession with weaker finances

Markets are now in a late stage of the current cycle, with extremes of sentiment on the upside and downside.

Given this uncertainty, capital conservation tops the agenda of pension plans. Their principal risk metric is the likelihood of a permanent impairment of capital. Yet, they also realise that to be too risk averse is the biggest risk that defined benefit plans face, given the current state of their funding level (Figure 1.6, left chart). Only 29% of them have levels above the statutory requirement of 100% in most countries. A further quarter have them below 90%.

The principal risk metric is the likelihood of a permanent impairment of capital.

The numbers are all the more worrying against the backcloth of the longest bull market in history. The main culprit is falling interest rates. They mean lower cashflows, as plans typically rely on bonds to fund regular pay-outs to their retirees. To cover the resulting shortfall, they have to invest even more.

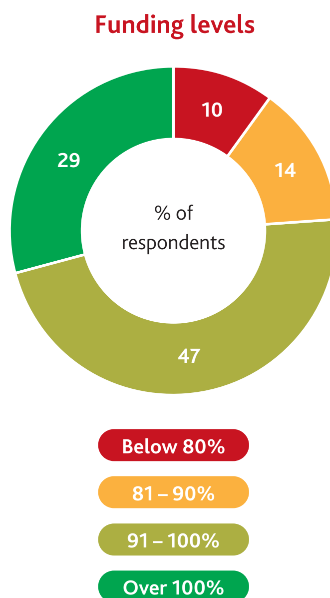
Falling rates also inflate the present value of future liabilities, as measured under prevailing pension regulation. As a ball park estimate, a 1 per cent fall in rates delivers a 20% rise in pension liabilities and a 10 per cent fall in the funding ratio – a measure of a plan's ability to meet its future commitments.

Pension plans are thus relying on two avenues to improve their funding levels: fresh one-off cash injections from their sponsors and an approach to investing that favours equities, illiquid assets and emerging market assets, as described previously.

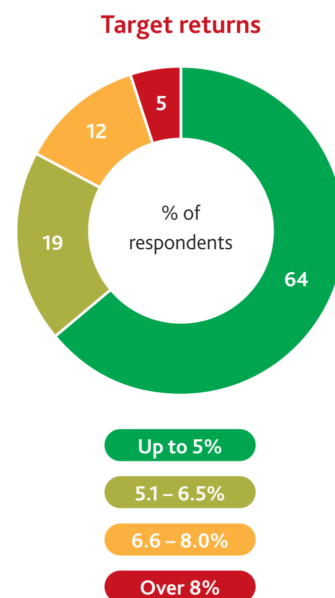
A third of them are targeting net returns in excess of 5% and the rest are aiming for up to 5% (Figure 1.6, right chart). With QE having borrowed against future returns, it will be a challenge to obtain anything in excess of 5% without leverage and/or aggressive risk taking.

Figure 1.6

If you're a DB plan, what is your current funding level?



What return (net of fees) do you target for meeting it?



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"We are learning to live with volatility – as a matter of choice rather than necessity."

"We'll fail if we equate risk with opportunity. Today, risk also means unknown outcomes."

Theme 4 Back to basics is the new mantra

Growth and inflation have fallen short of expectations in this decade in the West. It is doubtful if the next round of QE in the US and Europe will be any different, with one exception: its boost to asset prices will likely be a lot milder after the initial sugar rush.

Just as the current bull market has been the most unloved in history, so also might be the bear market that follows it.

Just as the current bull market has been the most unloved in history, so also might the next bear market that follows it.

Hence, uppermost in the minds of pension plans is the sequence of returns risk. It is defined as the likelihood that they will suffer a major portfolio loss in falling markets, just when their own cash flows turn negative due to ageing demographics, leaving too little time to recoup their losses.

Currently, 33% have a positive cash flow and 40% have a negative one (Figure 1.7, left chart). Most plans are already in their run-off phase, with the first – and the largest – cohort of post-war Baby Boomers now entering retirement.

Accordingly, on balance, their risk appetite is diminishing (Figure 1.7, right chart). Three avenues are being used to conserve capital (shown in Section 3).

The first one seeks greater time alignment between asset allocation and the maturity profile of pension liabilities (cited by 87% of the respondents).

The second avenue treats liquidity management as a primary risk management tool, since changes in the structure of bond and equity markets in this decade have ensured that liquidity evaporates just when it is most needed (62%).

The third avenue is duration management (37%), with a focus on under-valued assets across the yield curve (37%).

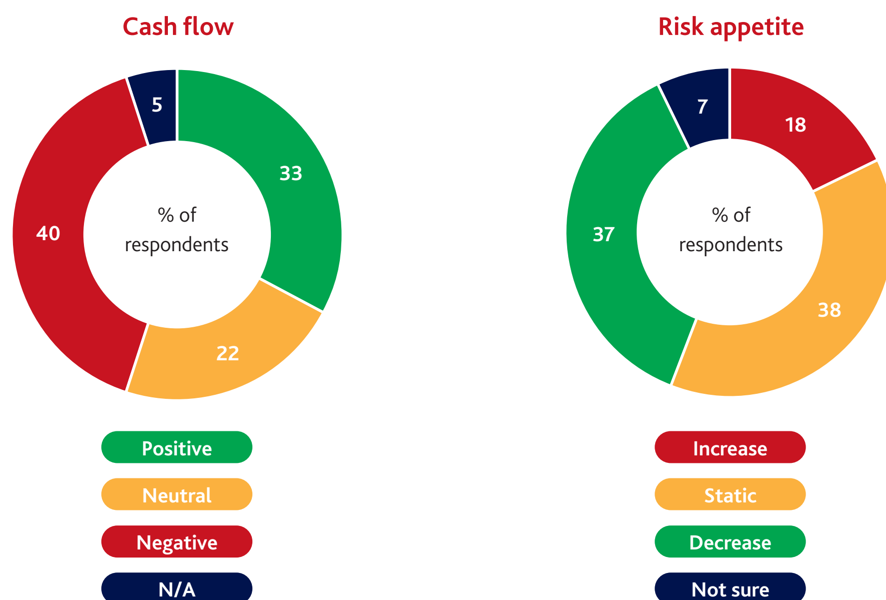
In the process, there is renewed emphasis on minimising implementation leakage: the errors made by pension plans themselves in designing and implementing their portfolios that only become evident in hindsight.

Improving governance structures and skill sets have raced up the agenda.

Figure 1.7

What is the net cash flow status of your pension plan currently?

Looking ahead, what will happen to the overall risk appetite of your pension plan?



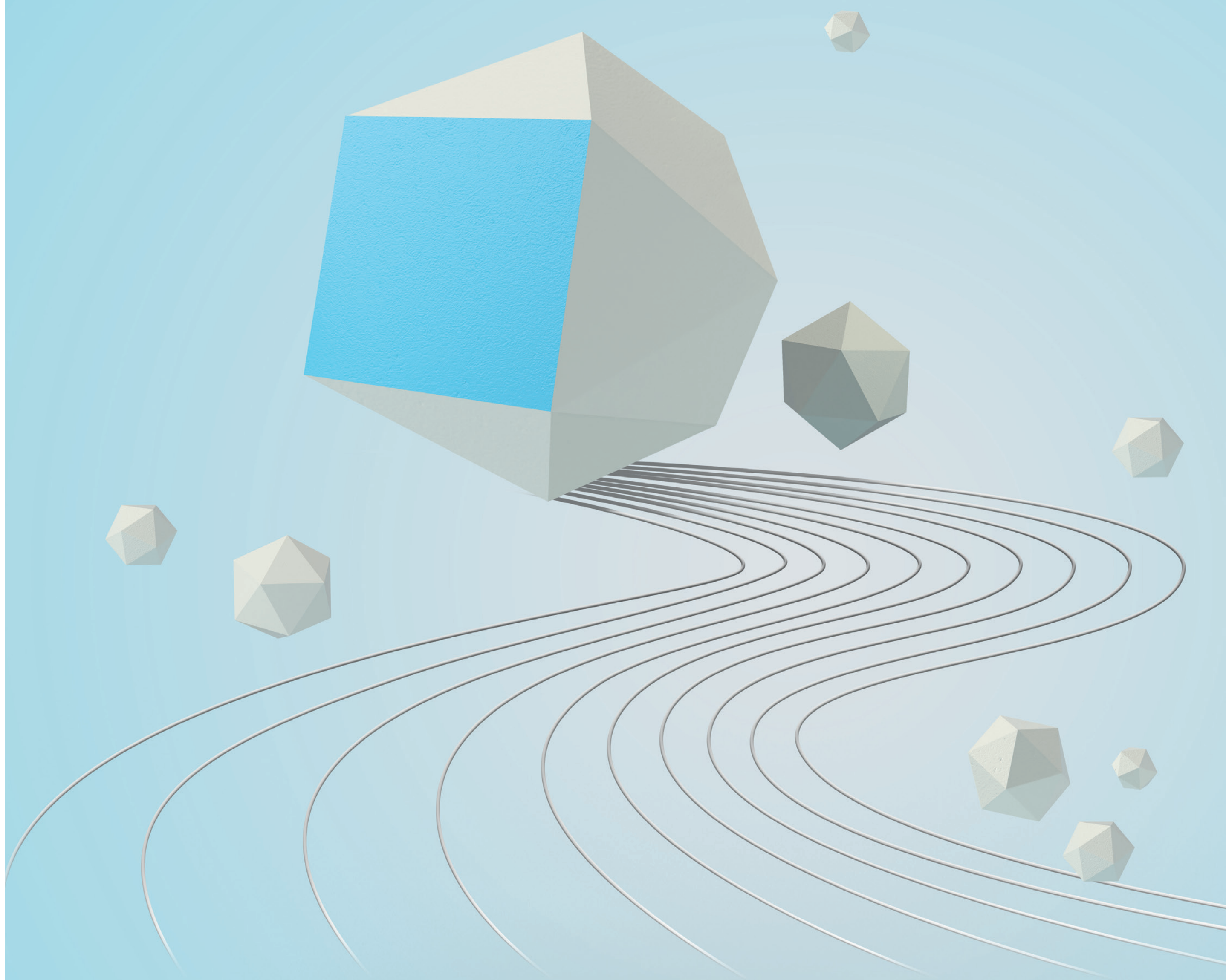
Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"There are too many political risks that can't be modelled in a spreadsheet."

"Behavioural biases mean we're always looking in the rear-view mirror."

2 Quantitative easing in action:
What is the scorecard so far?



Overview

Aims

Making a retrospective assessment of quantitative easing since its introduction in 2009, this section highlights:

- its positive effects so far
- its negative effects.

Key findings

a. Positive effects

QE was billed as a crisis-era measure. It has lived up to that role. As such, its benefits were more immediate. They include:

- stabilising financial markets that were rocked by the Lehman collapse in 2008
- delivering good returns on riskier assets by rebooting financial markets
- easing debt financing for governments, companies and households, against the background of severe liquidity shortages
- kick-starting growth in the global economy after a catastrophic global economic meltdown in 2008
- giving governments time to implement reforms to tackle the forces that sparked the crisis.

However, low rates are here to stay for the foreseeable future, as unwinding QE is proving an uphill task.

"Without growth and inflation, central banks are trapped in easy money policies for decades."

An interview quote

b. Negative effects

As unintended consequences, negative effects have snared QE in a trap from which it cannot extricate itself easily. These include:

- allowing global debt to rise inexorably
- sowing the seeds of the next financial crisis
- over-inflating pension liabilities via ultra-low discount rates
- disconnecting asset prices from their underlying value drivers
- giving governments an excuse to backslide on essential reforms
- borrowing against future investment returns by over-inflating current asset prices.

Prospects for significant deleveraging remain dim:

- government finances are too stretched to spark a new round of supply-side policies
- the rise of populism has also ruled out controversial painful reforms
- banks are unable to stomach defaults or debt forgiveness
- governments are loath to rely on the self-correcting powers of the markets for fear of social dislocation.

After the crisis, the choice for policy makers was simple: pain now or agony later. They chose the second, ushering in a long period of relative stagnation.

QE forever beckons.

QE has worked but mostly as a crisis-era measure

QE gave governments time to implement supply-side reforms in order to boost economic growth.

Described as an unconventional policy measure at the outset, designed to stave off worldwide depression in the immediate aftermath of the Lehman collapse in 2008, QE has delivered what it promised. But it has fallen short of what was expected (Figure 2.1).

67% of our respondents in the pension plan survey cited that QE has helped to stabilise financial markets rocked by the worst recession since 1929. As the credit bubble burst in 2008, key economies nose-dived into a severe balance sheet recession under the weight of unprecedented global debt.

By providing essential liquidity, QE not only helped to limit its depth in all the key economies. It also prevented a prolonged meltdown in financial markets and sparked what is, in hindsight, the longest bull run in history (cited by 58%).

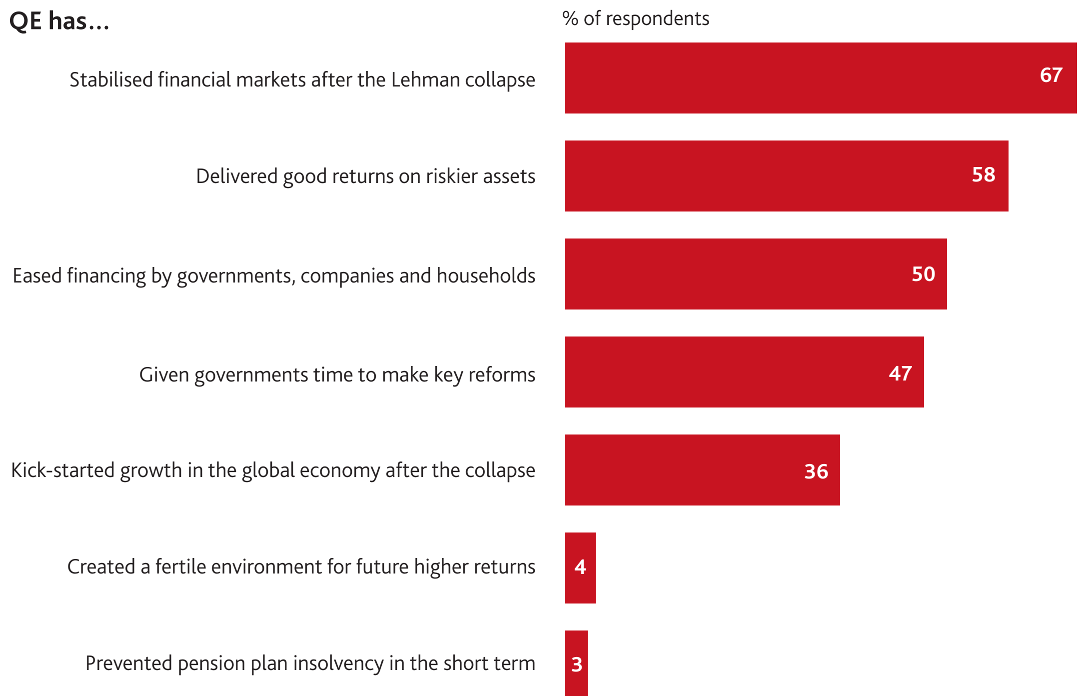
That apart, it also eased debt financing for governments, companies and households, via zero-bound interest rates and bond purchases, at a time of severe balance sheet pressures (50% of respondents).

Above all, QE gave governments time to implement supply-side reforms in order to boost economic growth (47%). These were essential to cope with the rise of globalisation and artificial intelligence which, as side effects, caused huge inequalities in most Western countries. These required more interventionist policies in areas such as education, training, welfare, competition and innovation.

36% of respondents believe that QE helped to kick-start growth in the global economy, in the hope that ultra-loose monetary policies would act as a major stimulus.

Whilst it reignited the growth engines, the boost was sporadic, uneven and not enough to deliver a sustained recovery. In hindsight, QE could not go on inspiring households and companies to bring forward their future spending plans in a climate of cheap finance and rising inflationary expectations.

Figure 2.1 Which of the following positive statements reflects your views about the impact of QE so far? (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"QE kept our economies afloat after the second worst economic crisis in 100 years."

"QE delivered all that it could do, but it was less than what was needed."

Low rates are expected to remain embedded in the global economy and change the nature of policies used to manage business cycles historically.

Nor has it created a fertile environment for higher returns in the future, since it has merely brought forward future returns to the present (4%). Nor did it help to prevent financial stress amongst pension plans, because their liabilities just ballooned uncontrollably under ultra-low rates (3%).

Thus, the main advantage of QE was to prevent a worst-case scenario and give governments time to tackle the deep-seated structural problems that sparked the 2008 crisis: cheap credit, growing inequalities, skills shortages, falling competitiveness and lack of innovation.

On the flip side, unwinding QE has proved an uphill task. Withdrawing liquidity and credit supply will destabilise today's fragile financial system, which has been fed on a diet of zero-bound rates for nearly a decade.

Global debt is at its all-time high and keeps zombie borrowers afloat. Rate rises could easily tip the global economy into recession.

For investors, QE has suppressed volatility, herded investors up the risk curve and effectively put a floor under asset prices. All this in the belief that central banks will come to the rescue at every whiff of a market correction, like a sugar daddy.

Thus, rises in interest rates can have adverse effects on the real economy as well as financial markets, at a time when debt, demographics and technology are already bearing down heavily on rates.

Hence, low rates are expected to remain embedded in the global economy and change the nature of policies used to manage business cycles historically. This has a bearing on how assets are managed, as we shall see in Section 3.

Interview quotes

"Normalising monetary policy can destabilise markets and kill off an anaemic recovery."

"Despite ten years of QE, the world economy is increasingly on borrowed time."

Insights

Modern Monetary Theory: the next step?

QE has worked as a crisis measure. It has not restored growth to its long-term trend, nor has it arrested the steady accumulation of unsustainable debt or improved personal income for the masses – the things that occurred in previous periods of economic expansion. If anything, via asset price inflation, it has accentuated the income inequalities in our societies and fuelled the rise of populism.

We worry that QE is now driving major economies on both sides of the Atlantic into a deflationary zero-interest funk of the sort experienced by Japan since the 1990s. The global economy is now exposed to various macro risks that could easily tip it into another recession. They include the trade war between America and China, a disorderly Brexit withdrawal, high debts in so many economies, the incomplete institutional architecture of the euro zone, and structural policy inertia.

Fiscal policy in the key economies has been slow to respond because their public debt burden is unsustainably high, leaving little leeway to implement the required supply-side reforms and big infrastructure projects.

Thus, the end-game of QE may well be the adoption of MMT – a fashionable heterodox doctrine based on the view that traditional macroeconomic frameworks are no longer fit for purpose in this decade. It argues that QE has failed to provide the boost that economies need. So, it advocates huge rises in public spending, alongside job guarantees and minimum basic incomes. Such policies have been tried in the past in Latin American countries. After the initial jobs boost, triple-digit inflation and massive devaluations have been the principal outcomes.

The Democratic Party in the US and the Labour Party in the UK are keen to implement aspects of MMT. These could take us back to the inflationary 1970s which saw extreme volatility in financial markets and political upheavals. It is unwise to rule out 'stagflation', which has followed periods of huge budget deficits funded by money printing in the past; nor moral hazard, when policy makers do not take responsibility for their actions.

~ A Swedish pension plan

QE is caught in a debt trap of its own making

The 'wealth effect' generated by rising asset prices has not trickled down into the economy on the scale central banks had anticipated.

Most of the respondents to our pension plan survey accept the counter-factual as a given: namely, such was the severity of the 2008 credit crisis that without QE another Great Depression was imminent. Thus, while highlighting QE's negatives, they see them as the lesser of two evils (Figure 2.2).

By far the most widely perceived negative is that QE has allowed global debt to rise inexorably and has depressed interest rates (cited by 78%). Since 2008, public and private debt in key economies has shot up by some $60tn to more than $200tn, about 300% of global GDP.

In the past, such high levels have been brought down by economic growth and inflation. In this decade, neither has done the trick (see Insights on the next page).

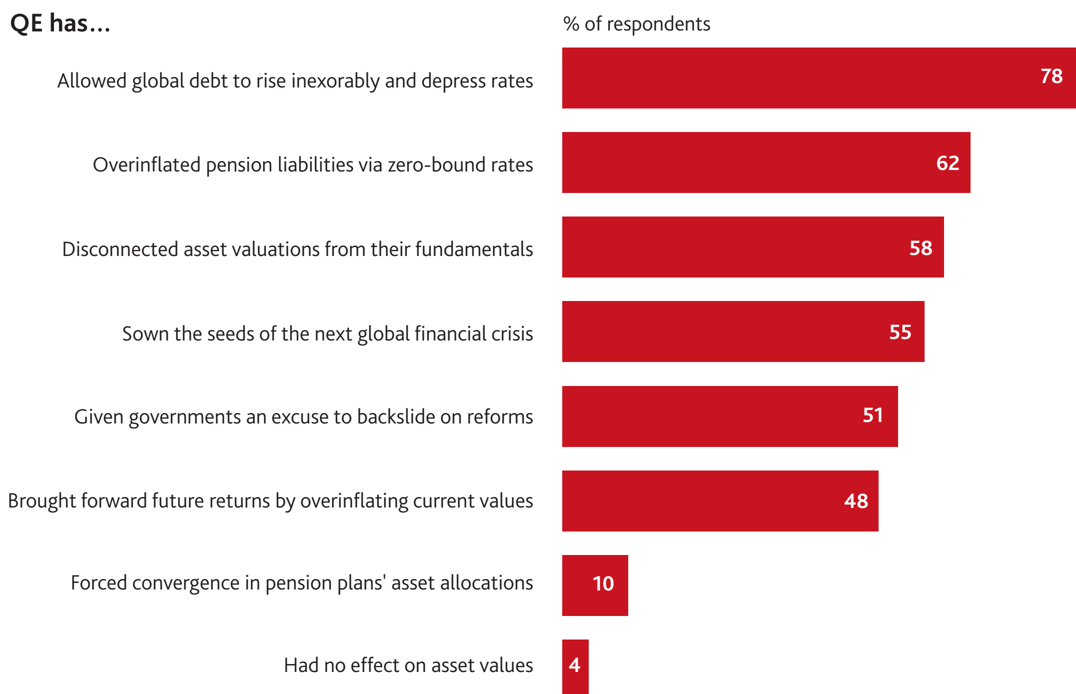
In the meantime, governments are relying on 'financial repression' – whereby central banks keep interest rates artificially low to manage the massive expansion in their governments' debt. While it makes sovereign debt more affordable, it plays havoc with savers, investors and pensioners.

Unsurprisingly, therefore, 55% of respondents believe that QE has sown the seeds of the next financial crisis by allowing debt to balloon without regard to growth in GDP or to its distributional impact.

They see key economies caught in the classical 'liquidity trap' where injections of cash into the economy fail to stimulate growth, whatever the borrowing rates. Households and companies prefer to hoard cash or buy financial assets until governments tackle deep-seated supply-side issues.

The 'wealth effect' generated by rising asset prices has not trickled down into the economy on the scale central banks had anticipated. Their conventional multipliers have proved less potent.

Figure 2.2 Which of the following negative statements reflects your views about QE's impacts so far? (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"A decade of QE has not healed the real economy. Why would more of it work?"

"Politicians need to stop kicking the can down the road and adopt essential reforms."

Prospects for significant deleveraging remain slim. The credit boom that caused the crisis in 2008 continues to cast a long shadow.

Hence, 51% of respondents believe that QE has given governments an excuse to backslide on essential reforms in slow-burn areas such as welfare, education, training, innovation and competition. The visceral anger against banks after the 2008 crisis has made it harder to drive much-needed reforms that inflict pain on the general public in the West.

When banking losses after the Lehman crisis were socialised, what started as a financial problem turned into a structural one. Big government deficits have dented confidence and have since undermined growth.

62% of respondents also worry about the crippling effects of low interest rates on pension liabilities. As rates have dropped like a stone in this decade, the present (i.e. discounted) value of future liabilities has ballooned, dragging plan deficits well below the statutory levels in many pension markets.

58% of respondents also remain concerned that QE has disconnected asset valuations from their underlying fundamentals. At the other extreme, only 4% believe that QE has had no effect on asset values. Age-old notions of risk premia, time premia, fair value, correlation and mean reversion have been side-lined; with little indication as to the nature of new risks stoked up in the process by excess liquidity.

Historically, excessive leverage has been reduced by policies that promote a combination of economic growth, inflation, and defaults or debt forgiveness. QE has relied on boosting the first two – with limited success.

The last two have been ruled out, since a lot of debt sits with banks, who have had to repair their balance sheets after the crisis to comply with new regulations in the banking system.

Thus, prospects for significant deleveraging remain slim. The credit boom that caused the crisis in 2008 continues to cast a long shadow. Governments are unable to act; yet, they are also unwilling to rely on the self-correcting powers of the markets for fear of social dislocation.

Interview quotes

"There is a lot of soul searching about where the global economy is headed."

"Historically, credit booms have always ended in tears."

Insights

Dealing with a debt-addicted growth model

Low rates have undermined markets' traditional role in allocating resources to their most profitable use. Zombie borrowers abound: ones unable to cover their debt service costs from profits or incomes. A growing proportion of new debt is short-term. Not many borrowers have sufficient operating cash flows to repay it. So new borrowings are needed to retire the old ones and maintain solvency.

A 1% rise in rates would raise household debt payments by 7% in the US and 19% in the UK.

Overall, rising debt has helped to generate demand by fast forwarding future spending.

Reportedly, more than 80% of such debt has gone into existing financial assets or consumption; not into investment in new equipment, skills or innovation – productive assets that create jobs and prosperity.

Even central banks are heavily leveraged. Today, the US Federal Reserve has around $60bn in capital supporting assets of around $4tn; the ECB has €10bn supporting assets of €3tn; the Bank of Japan has ¥3tn supporting assets of ¥160tn; and the Bank of England has £3.3bn supporting assets of around £350bn.

When it comes to the next recession, central banks will not only have a bloated balance sheet but also little latitude in lowering interest rates, if history is any guide. For example, the Fed has relied on policy rate cuts of about 5 percentage points to reverse a normal recession in previous cycles.

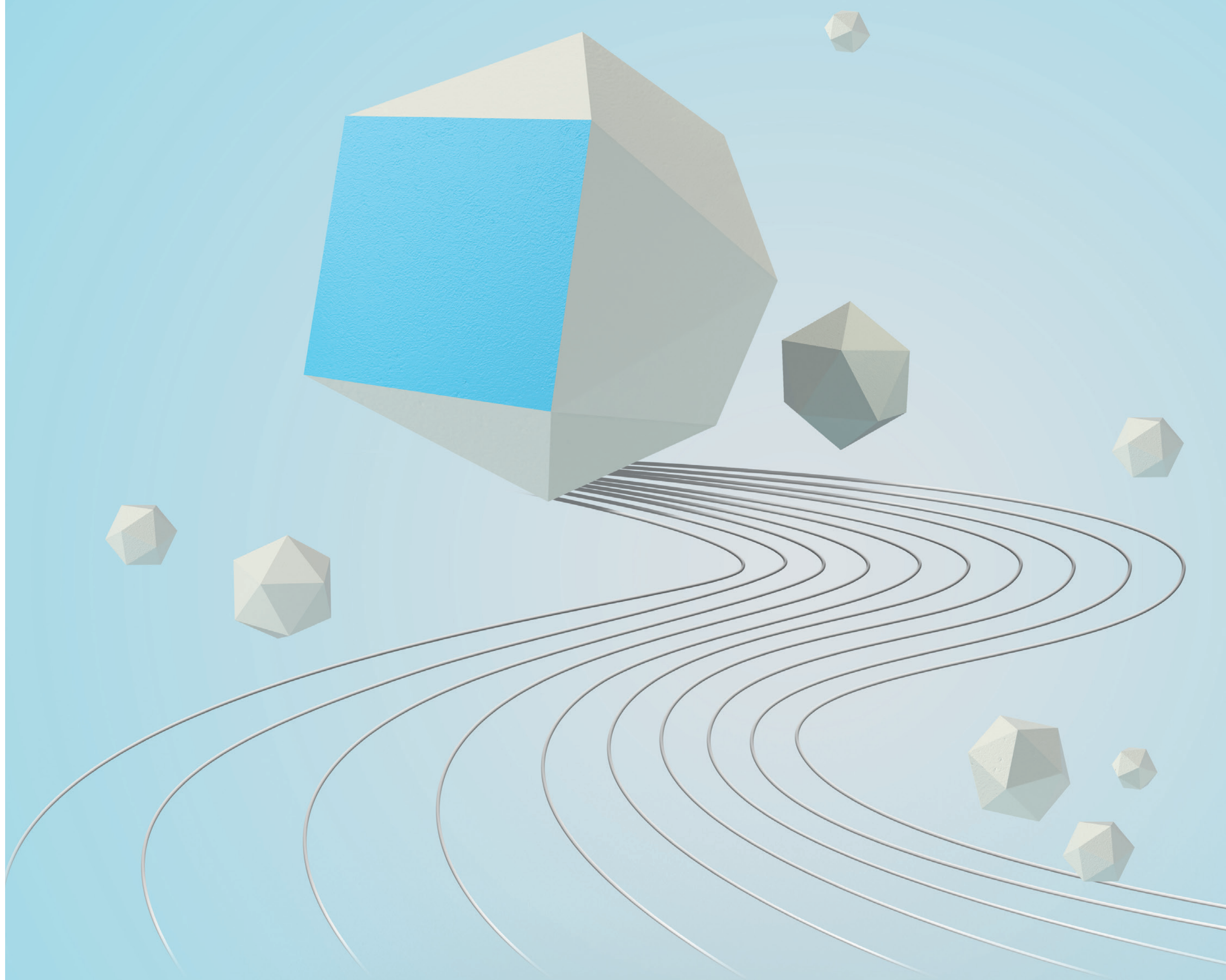
Now, none of the advanced economies has anything resembling this degree of monetary 'dry powder'. If anything, policy rates in Denmark, Sweden and Japan remain firmly mired in negative territory.

It remains unclear how the current debt mountain is likely to shrink in the foreseeable future.

~ A global pension consultancy

3 Asset allocation in an era of QE:

What are the key imperatives?



Overview

Aims

Looking forward, this section focuses on asset allocation as QE enters an extended phase. It highlights:

- the investment goals that are being pursued
- the asset allocation tools that are being deployed to pursue the goals
- the asset classes that are being favoured in the process.

"Our return expectations are lower for all asset classes."

An interview quote

Key findings

a. Investment goals

As financial markets have entered the late-stage in the current cycle, the scope for policy error remains big. Capital conservation and liquidity management have become the principal goals.

They are being pursued by:

- a broad asset class diversification
- a strong focus on liquidity in asset choices
- duration management to minimise the effect of interest rate changes on fixed income assets.

b. Asset allocation tools

There is clear recognition that today's sky-high asset valuations are not rooted in the reality of the global economy.

So, asset allocation now relies ever more on:

- a diversification based on risk factors more than asset classes
- secular themes that capitalise on growth points in the global economy that are not exposed to secular stagnation
- longer holding periods that allow for risk premia to materialise
- under-valued assets that are subject to mean reversion
- a clear separation of alpha and beta assets to minimise portfolio costs.

c. Asset classes

Three asset classes are being favoured:

- defensive equities to obtain decent yield at a time when pension plans' cash flows turn negative due to ageing membership
- illiquid assets to earn better returns and reduce the mark-to-market risk
- emerging market assets to capitalise on their long-term growth dynamics.

Fixed income assets are seen as too risky due to compressed credit curve and tighter spreads.

Capital conservation is vital in a late-stage cycle

The yield curves in all the key economies are already flashing red.

Markets are in a late stage of the current cycle – with extremes of sentiment on the upside and downside, leaving cautious investors nowhere to go.

Looking back, this decade has been unusually favourable for investors: the S&P 500 racked up an annualised return of 16% in what is often dubbed the TINA market: where there is no alternative to risky assets so long as QE provides the safety net. The next five years are likely to provide a sterner test, however.

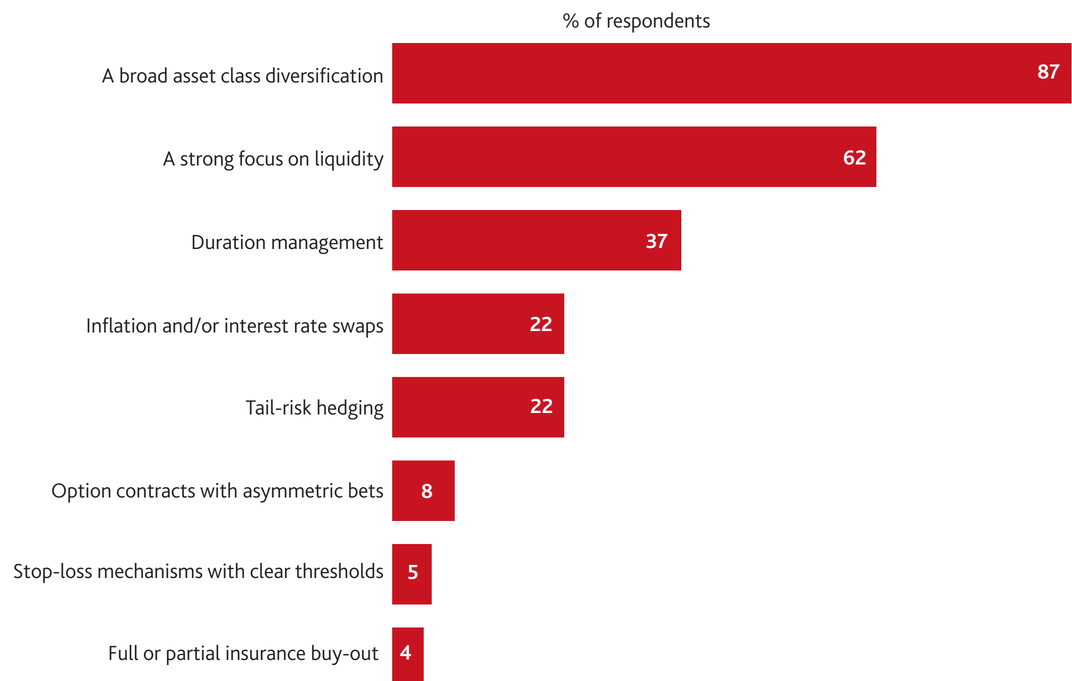
First, there is growing scope for policy error in the latest round of rate cuts. The line between 'pre-emptive' and 'reactive' cuts is thin: one is friendly towards markets, the other signals a recession. Second, President Trump's on-again-off-again trade war has been denting business and consumer confidence. It risks escalating into currency wars. Third, a raft of idiosyncratic risks is looming on the horizon: ranging from a Chinese credit crunch to a disorderly Brexit. Finally, a populist backlash against post-crisis policies, that accentuated income and wealth inequalities, may well result in higher corporate taxes and new business regulation. The chorus for higher fiscal deficits is getting louder by the day.

Hence, the prevailing investment narrative seems to be reversing: from "bad news for the economy is good news for risky assets" to "bad news for the economy is bad news all round". The yield curves in all the key economies are already flashing red.

Pension plans remain worried that there will not be a globally coordinated response in the next crisis – like in 2009 – as the global economy veers towards beggar-thy-neighbour polices from the rise of nationalism.

Hence, back to basics is the new mantra. It rests on the view that markets will begin to reconnect with their fundamentals as QE passes the point of diminishing returns. But given the extreme uncertainty, capital

Figure 3.1 **What approaches does your pension plan use in order to manage risks in your portfolio while real yield remains so low and equity markets remain so high?** (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"Investors are presented with a confusing array of signals pointing in different directions."

"We just have to stop hoping that next year things will be better."

Accept the possibility that risk premia may be time-varying, taking longer to materialise, as asset prices gradually reflect fair value.

conservation is the key goal currently: making money by not losing it. The key risk metric is the likelihood of a permanent impairment of capital. It is now being pursued via three key avenues (Figure 3.1).

The first one is a broad diversification with greater alignment between asset allocation and the maturity profile of pension liabilities (cited by 87% of respondents). Such time-based diversification duly draws a distinction between private and public markets and uses different asset classes to target one or more of four goals: capital growth, regular cash flow, inflation protection and lower volatility. It also accepts the possibility that risk premia may be time-varying, taking longer to materialise, as asset prices gradually reflect fair value.

The second avenue puts liquidity centre stage (62%). It helps to manage any risk by allowing pension plans to implement their investment views in real time. Assets are thus allocated according to their liquidity features, duly taking into account the rising fragility of financial markets due to structural and technical changes in this decade (see Insights).

The third avenue is duration (37%). With rates likely to remain low-for-longer, pension plans are able to operate across the entire yield curve in search of under-researched assets.

Notably, other avenues like inflation, interest rate or tail-risk hedges are being deployed by only one in every five respondents. Their cost aside, they add complexity to the portfolio. They are also exposed to counter-party risks, if many investors are forced to activate their hedges at the same time.

Interview quotes

"Liquidity is the cornerstone of diversification. It allows us to express our views in real time."

"We want to profit from being liquidity providers in periods of market dislocation."

Insights

Liquidity as a primary risk management tool

The next big market downturn will be the first since the 2008 crisis. Since then, there have been growing concerns over whether there will be enough liquidity next time, due to various recent structural and technical changes that are adding to market fragility.

On the structural side, regulation in America and Europe has curtailed the market-making role of investment banks, especially in fixed income instruments. The role of equity markets, too, has morphed from a source of raising investment capital for growing companies to a vehicle for cash distribution and balance sheet management; as shown by massive share buybacks on both sides of the Atlantic.

Finally, private markets, for their part, now offer new potential return streams from themes like growth, innovation, and business restructuring.

On the technical side, the rise of high-frequency trading has been a source of market volatility. Their algorithms are trained to minimise risks: at every sign, they quickly withdraw liquidity from markets.

Additionally, even in supposedly liquid equity markets, the liquidity parameters have altered due to the ever-growing volume of assets migrating from bottom-up stock picking to formulaic-based index funds and volatility-based systematic strategies. Assets are not priced to adequately compensate our pension clients for liquidity shortages in the next market correction, when it comes.

Our clients are therefore resorting to time-based diversification that mimics the profile of their liabilities. They assume more risk in illiquid private markets for those liabilities that mature in the distant future. They put the rest in public markets where they can be nimbler, while riding out uncompensated illiquidity risks from time to time.

In both markets, they are holding 'dry powder'. The aim is capital conservation, backed by opportunism to take advantage of periodic dislocations that lie ahead.

A Dutch pension consultancy

There is a limit to how high today's asset valuations can go

Back to basics is the new mantra, but it will mean having to do old things better.

When markets are flirting with their all-time highs, a lot can go wrong at once. Our survey respondents remain worried about the way the US–China trade dispute is escalating into a technological arms race. Another concern is President Trump's latest idea that Chinese companies should no longer be able to list on the US stock exchanges. They are also worried that neither central banks nor governments can foster international coordination in this beggar-thy-neighbour world of populism.

Just as the current bull market has been the most unloved in history, so also will be the possible bear market that follows it. Central banks have not achieved their stated aims on growth and inflation in this decade. It is doubtful if the next round of QE in the US and Europe will be any different, with one exception: its boost to asset prices will be a lot milder after the initial sugar rush.

There are no new asset classes or better mouse traps that can deliver improved sustainable returns as we enter the low return/high volatility environment of the next decade. Hence, back to basics is the new mantra, but it will mean having to do old things better (Figure 3.2).

61% of our pension plan respondents are adopting risk factor investing. Some are venturing into it for the first time; others are refining it to embrace multiple factors. This new approach to diversification is deemed superior to the one based on asset classes, since it minimises the rising asset class correlation that has diluted diversification benefits in the past.

55% of respondents are pursuing secular themes because subpar growth in large economies have reinforced the view that they are trapped in secular stagnation despite unprecedented monetary and fiscal stimuli after the crisis.

Figure 3.2 **Which of the following actions are being taken by your pension plan to protect your portfolio while quantitative easing lasts?** (Pension plan survey)

Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"QE has turned from a medicine into a drug and rate cutting has diminished potency."

"QE provided an amazing joy ride. But payback time cannot be put off indefinitely."

Secular themes can allow investors to focus on selective growth points in the global economy, overshadowed by secular stagnation.

Hence, there is now a decreased likelihood of small loss events but an increased likelihood of a big loss event. In response, secular themes – like ESG, emerging markets, technology – can allow investors to focus on selective growth points in the global economy, overshadowed by secular stagnation. Such themes have the momentum of a supertanker: powerful and invariant.

53% of respondents are adopting longer time horizons: some are planning to hold their fixed income assets to maturity to avoid being caught up in a liquidity crisis; and some are assuming that risk premia of many asset classes will take longer to materialise, as the distortionary impact of QE wears off incrementally.

51% are seeking undervalued assets by acting as liquidity providers in periods of market stress. The majority of them remain overweight in cash in the belief that the next big correction will open up buying opportunities across all asset classes so artificially boosted by QE.

49% of respondents are having a clear separation between alpha and beta assets in order to ensure that they do not pay alpha fees for beta performance.

35% are using ETFs as a cash equitization tool – while rates are so low – as well as for pursuing different themes at different phases of the market cycle.

The underlying imperative behind the return to basics is simple: in periods of turbulence like wars and financial crises, markets always become unhinged from their fundamentals only to reconnect once the dust settles.

In this decade, the degree of disconnect has veered between two extremes: a massive fall during the 2008 crisis and a massive rise thereafter powered mostly by QE. With QE reaching a point of diminishing return, there is expectation that notions of risk premium, time premium, fair value, diversification and mean reversion will gradually kick-in. The question is not 'if' but 'when'.

Interview quotes

"There are no panaceas in investing. Only common sense."

"Value investing is far from having one foot in the grave. It is returning in a different guise."

Insights

Back to basics

Mean reversion will kick-in before long – in markets and individual assets. Basic investment principles, sidelined by QE, will reassert themselves. So, we have been refining our approaches.

The first one relates to factor investing. QE has promoted unprecedented herding among investors. Due to recency bias, many of them still target the bandwagon premium in the hope that upward momentum will persist by placing too much emphasis on recent events; while ignoring the fact that markets are reverting to fundamentals via periodic volatility bouts. We are exploiting this via a blend of four risk factors: quality, momentum, value and low variance.

Additionally, we are refining our definition of value stocks.

Since the start of the Russell 3000 Value index in 1978, value stocks outperformed the broad market by 1.1% annually in the US through 2006. Since then, they have traded at a discount as high as 35%. One reason is that the higher-than-market yield that they offered in the past has been hard to get in today's expensive markets.

Another reason is that intangible assets – ideas, R&D, branding and corporate culture – have not featured in the book value of companies because they are hard to measure. We have thus reduced reliance on book value and created indirect indicators of these intangibles and refined our quality and value factors accordingly.

Thematic investing is another area featuring high in our asset allocation. We believe that certain secular trends are reshaping the global economy, while creating investment opportunities in the process. Being long term in nature, they do not readily appear on investors' radar. The companies affected by them often trade at a discount; only to experience a powerful bandwagon effect as the potential becomes evident.

In this era of secular stagnation, such themes are helping to ride out market cycles and deliver good returns. The themes that we are pursuing are ESG, bank restructuring, emerging markets and artificial intelligence.

~ A Danish pension plan

Reducing mark-to-market volatility will be a key aim

The days of minor bad news sending the market skidding are back – so fickle is investor sentiment currently.

The age-old investment truism that 'what goes up must come down' is now firmly anchored into pension portfolios. The days of minor bad news sending the market skidding are back – so fickle is investor sentiment currently. Yet, as we saw in Themes 3 and 4 in the *Executive Summary*, they have to remain invested, given the toll taken by QE on their finances.

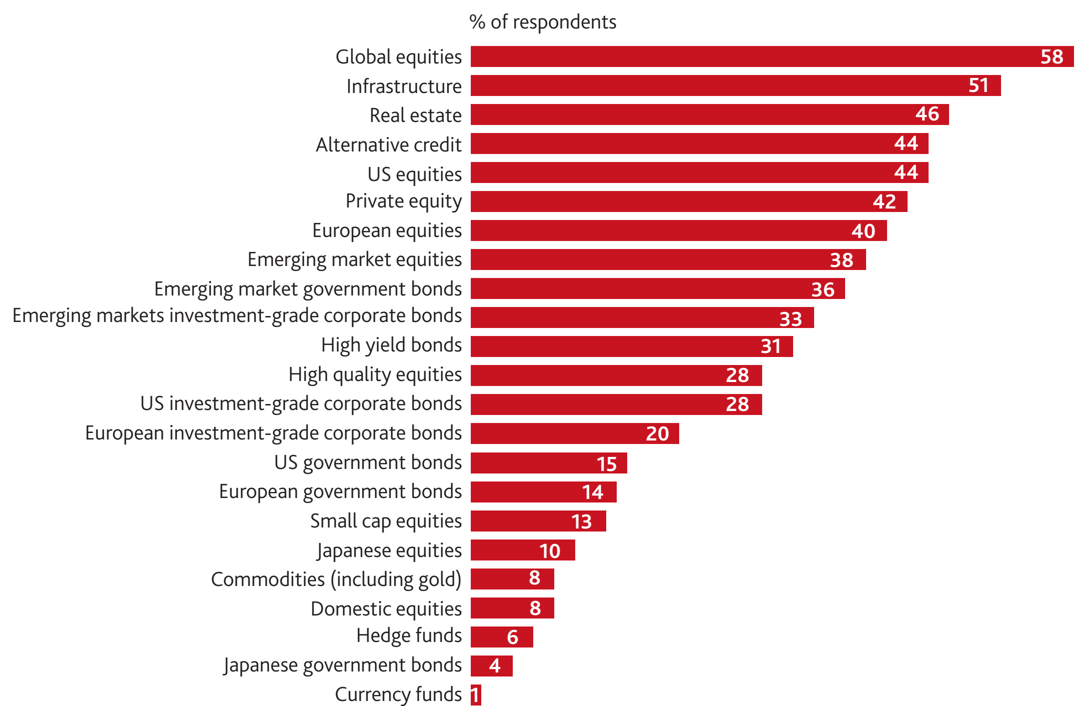
When the next big market correction comes, their most pressing aims will be to conserve capital and reduce the mark-to-market volatility that affects the balance sheets of plan sponsors. So, while QE lasts, some asset classes will be favoured more than others (Figure 3.3). Our post-survey interviews unearthed four underlying investment themes.

The first one is that equities will remain a favoured asset class: a defensive play offering a good yield and reasonable total return at a time when pension plans are advancing in negative cash flow territory owing to ageing membership. The ones that feature high on the list are: global equities, US equities, European equities and emerging market equities. In all cases, the favoured companies will have stable dividends, rising free cash flow, an admired brand, strong pricing power and, above all, a low market beta to contain volatility in asset prices.

The second theme is that periodic portfolio rebalancing will favour private market assets designed to deliver uncorrelated absolute returns. Topping the list will be infrastructure, real estate, alternative credit and private equity.

Their recent superior returns are one contributory factor. The other is their valuations are not marked-to-market and hence shield the portfolios from the volatility that normally buffets the public market assets. Currently, most of these asset classes hold a high level of 'dry powder' – uninvested capital – as good opportunities have diminished with strong inflows in this decade.

Figure 3.3 **Which asset classes will be most popular while quantitative easing lasts?** (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"Predicting the timing of future volatility episodes is a tough call."

"The eurozone could be a source of positive surprises. It's unwise to write it off."

Much of it is waiting to be deployed in periods of market dislocation.

The third theme relates to emerging market assets. Since the 'taper tantrum' in 2013, they have been negatively affected by a pernicious combination of rising US interest rates and the rising dollar. Economies with weak fundamentals or political instability – like Turkey, Argentina and Venezuela – have been especially hard hit. Elsewhere, reforms are rebalancing their economies and strengthening public finances.

EM assets are viewed as riding a secular wave which has been weakening the demarcation between developed and emerging markets.

China is a prominent case in point with its rise as a nascent technology superpower driving up its weight in global indices like MSCI. EM assets are thus viewed as riding a secular wave which has been weakening the demarcation between developed and emerging markets.

The final theme relates to bonds. Their risk–reward ratio, on balance, is seen as unfavourable, given the compressed credit curve and tighter spreads. Corporates have taken on ever more debt in response to low rates, making them vulnerable when the next recession comes.

Some pension plans – with healthy funding ratios – have locked into sovereign bonds, even at negative rates, to ensure that their liability profile mimics these assets. Their money sits in the much-derided global pile of $17tn of bonds with nominal negative yield. Some plans, on the other hand, are choosing assets that offer a mix of: decent yield, regular cash flow, inflation protection and some capital upside.

Overall, as pension plans enter the next decade, they no longer see US assets as a safe haven (see Insights). Having risen so high in this decade, their disconnect from the real economy is now all too obvious.

Interview quotes

"Infrastructure and real estate are good proxies for bonds."

"Before long, the redback will challenge the greenback in global financial markets."

Insights

There are no safe havens

In this decade, the US has surpassed other developed countries in terms of growth, being the first to reboot its banking system after the 2008 crisis. Its tech sector has propelled equity markets to fresh heights – to the point where valuations have now reached historical extremes compared with other global markets.

So far, investors worldwide have flocked to US assets as a safe haven in what has been a turbulent decade. Their high earnings multiples have been helped by tax cuts, subdued wages and lower borrowing costs. In each of these areas, the perceived advantages are now eroding. Pressure for wage hikes is building and is manifested in the agenda of the Democratic Party, as are corporate taxes.

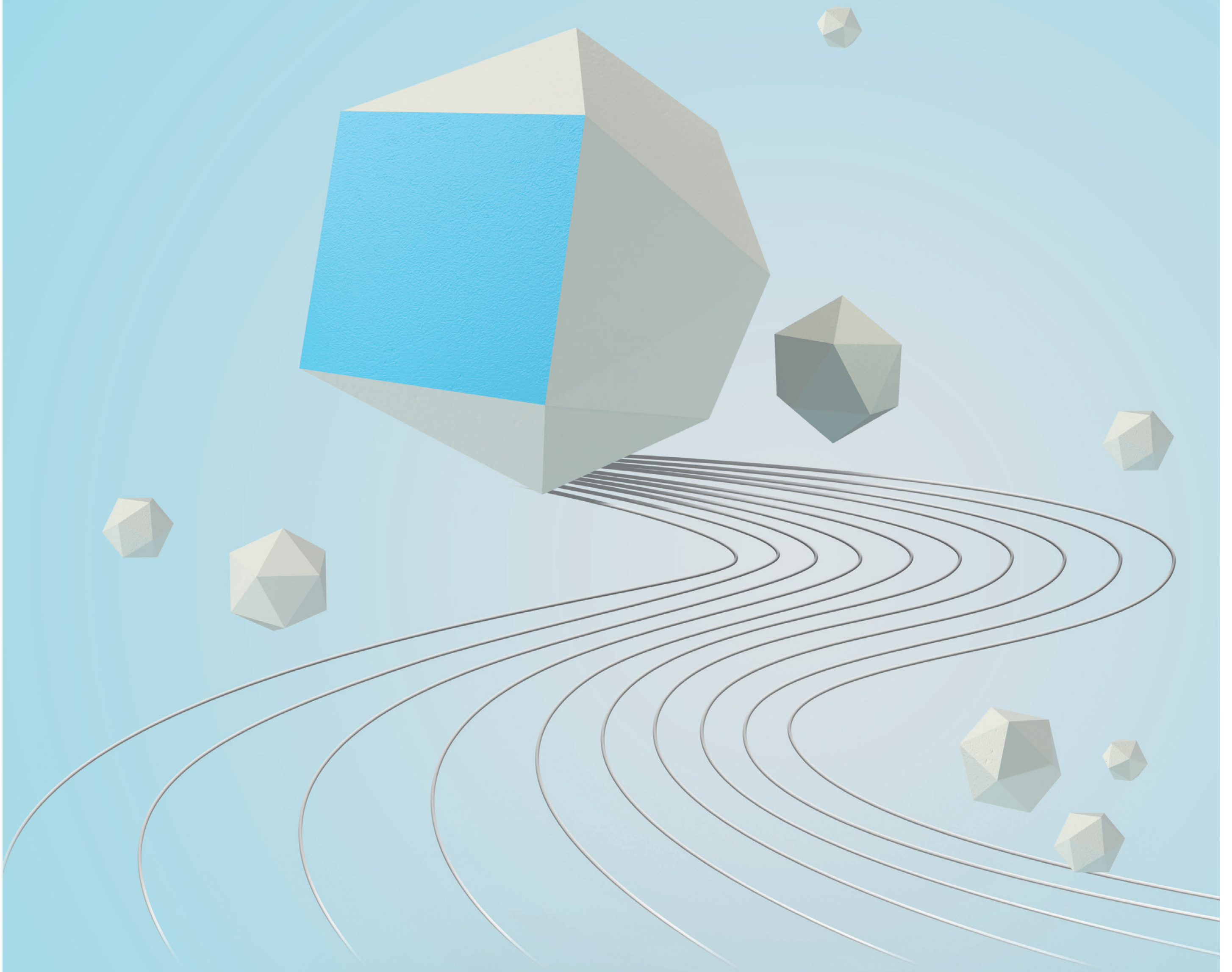
Additionally, the tariff war with China shows every sign of escalating. In the background, the technological arms race has been gaining traction. The next phase may be overt currency wars, which could badly hit world trade. The end-game is a big unknown. There is no certainty that the US will win.

Another factor undermining investor confidence is the Fed's abrupt U-turn last January, soon after confidently announcing that quantitative tightening was on autopilot. It showed either a poor understanding of what was going on in the economy or an inability to resist mounting political pressure from President Trump for rate cuts ahead of the 2020 general election. Either way, the Fed's credibility has been worryingly dented. How effective it will be when the next recession comes is anybody's guess.

After all, the Fed is a de facto central bank for the world while the US remains a dominant global economic power. Two-thirds of global securities issuance and FX reserves are denominated in US dollars; two-thirds of emerging market debt is denominated in US dollars; two-thirds of global GDP relies on the US dollar as a monetary anchor.

~ A UK pension plan

4 Business models:
What does savvy portfolio execution mean?



Overview

Aims

Taking a forward look, this section highlights:

- actions being taken by pension plans to reduce the 'implementation leakage' from their portfolios due to suboptimal execution
- pension plans' preferences on the current generation of business models in global asset management.

Key findings

"We work with asset managers who understand our dreams and nightmares. And put our interests above theirs."

An interview quote

a. Reducing implementation leakage

A number of actions are being taken by pension plans in the belief what they themselves do have big impact on portfolio returns. They include:

- rebalancing the portfolios towards low-cost options and negotiating lower fees for active funds
- strengthening investment expertise on the pension board
- deepening the in-house talent pool
- creating a nimble governance structure
- building specialised capabilities in private markets
- strengthening the sponsor covenant.

Overall, in a low return/high volatility environment, cost is seen as a key source of outperformance, when compounded over time.

b. Choosing the business models

QE has arbitrarily lifted all asset management business models, somewhat diluted their merits and blurred their boundary lines.

The focus has shifted from business models to specific asset managers who offer a strong alignment of interests and specialist liquidity management capabilities.

The following models remain in favour:

- specialised alpha boutique managers
- integrated houses with a range of alpha and beta capabilities across the water front of public and private markets
- multi-boutique houses with semi-autonomous specialist boutiques
- providers of customised solutions.

At a time when markets remain distorted, pension plans are keen to minimise the 'wrong-time' risk and 'regret' risk via strong engagement with their managers.

Better returns require minimal implementation leakage

Investing, like tennis, is often viewed as a *loser's game*: one in which the winner is not the one with the best strategy, but the one who makes fewer mistakes. Over the past 20 years, pension plans have learnt one fact of life: when it comes to asset allocation, there is the world of theory and the world of practice. Actual returns rarely match expected returns.

As QE has borrowed against future returns, markets are likely to be in extended periods of low returns and high volatility.

Unpredictable markets are one factor. For example, few asset allocation plans survived during the risk-on-risk-off cycles during the eurozone crisis in 2013-15. Another factor is the so-called implementation leakage: errors made by pension plans themselves in designing and implementing their portfolios that only become evident in hindsight.

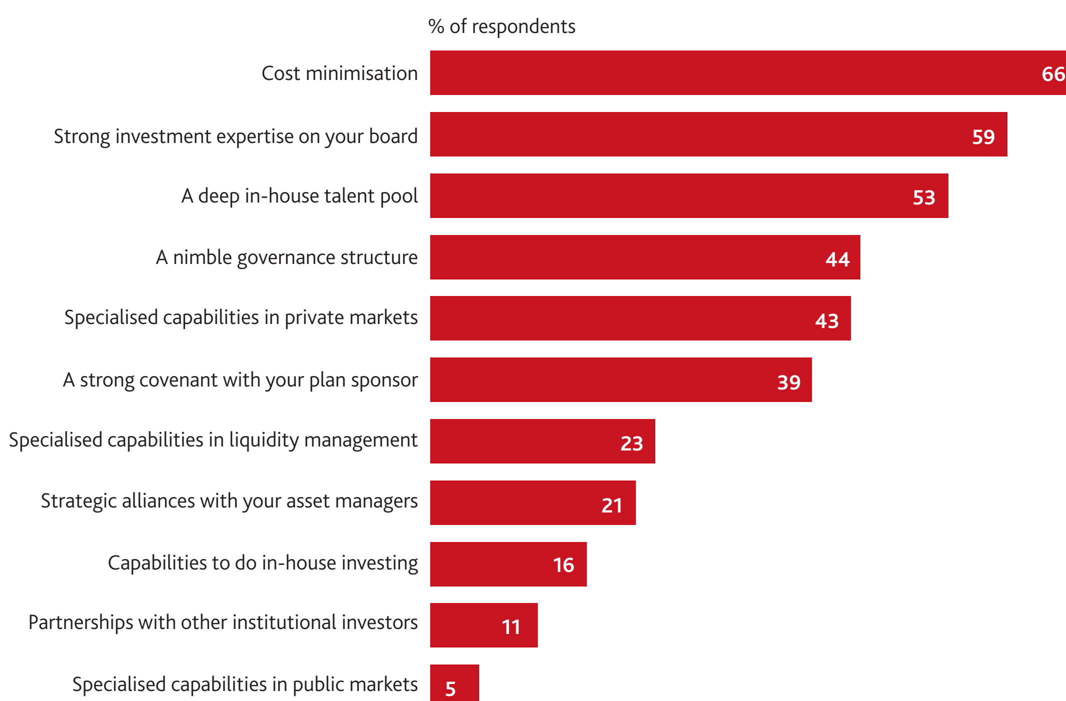
Hence the old adage that 'fix asset allocation and the numbers will follow' is only true when leakage is low. Pension plans have wised up about the sources of such leakage and taken the necessary steps to tackle its causes in this extended era of QE (Figure 4.1).

Cost minimisation tops the list (cited by 66% of respondents). By fuelling markets and containing volatility in this decade, QE has effectively turned investing into a one-way bet that has favoured passive funds. The resulting price distortion has prevented active managers from beating their benchmarks.

Hence pension plans have raised the share of passive funds as a low-cost option in their core portfolio. They have also forced fee compression in the active space. The best asset managers are able to retain their fee models; the vast majority are being forced to revise them. As QE has borrowed against future returns, markets are likely to be in extended periods of low returns and high volatility. Hence, costs are now seen as a key source of outperformance.

Strong investment expertise on pension trustee boards also ranks high on the list (highlighted by 59%); as are a deep talent pool among professional staff (53%) and a nimble governance structure (44%).

Figure 4.1 **What are the critical drivers of good returns that your pension plan is acting on?** (Pension plan survey)



Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"The genius of an investment strategy is more in execution than design. "

"Governance weaknesses are one of the key causes of the current malaise in the pension world."

After allocating the assets and implementing the portfolios, what pension plans themselves do matters a lot in delivering decent returns.

The aim is to develop new capabilities that help to reduce the principal–agency problem arising from a conflict of interest between pension plans and their advisers. It results when there is information asymmetry: advisers are better informed than their clients and at times offer advice that protects their own interests more than those of their clients.

Furthermore, as QE has sidelined much of the conventional investment wisdom, trustee boards are having to make big judgement calls without the normal navigational tools. The pressure on these boards to step up to the plate and effectively discharge their fiduciary role is mounting each day.

Finally, as we have seen in Section 3, portfolio rebalancing in terms of asset classes as well as timing has become a way of life. Diversifying into private markets is an essential part of it (43%). They have many distinctive features – due diligence, liquidity, defaults. These require both breadth and depth of expertise. Its importance is underscored by two general points.

First, after allocating the assets and implementing the portfolios, what pension plans themselves do matters a lot in influencing ultimate investment returns. Many strategies were hammered in the past due to herding in the pension industry, with no regard to the notions of prime-mover advantage and predefined exit plans.

Second, pension plans need to enhance their credibility in the eyes of their sponsors (39%) while they transition to negative cash flow status and below statutory funding levels. As liabilities have ballooned in this decade with ultra-low rates, many sponsors have been forced to make big one-off cash injections to ensure plan solvency. The covenant risk is probably at its all-time high now.

Interview quotes

"Peer risk and career risk prevail widely in the pension value chain."

"New ways of investing require new ways of thinking. Mindset shifts are essential."

Insights

Cost has become a source of returns when compounded over time

Academic studies that elevate the role of asset allocation in delivering good returns often overlook one fact: designing a portfolio is one thing, implementing it is quite another. The quality of governance structures and skill sets matter a lot in determining the end outcomes.

We learnt this lesson in the last decade after going into hedge funds and private equity, mimicking the iconic Yale and Harvard Foundations. In hindsight, we went in well after their peak returns were history. Since then, we have made two sets of changes.

The first set concerns plan governance. We have sought extra clarity in the long-term mission of the plan, its investment beliefs and its time horizon. We have recruited investment experts onto the board of trustees to ensure that our strategic calls are not overly influenced by pension consultants. We have also enhanced the skills of our full-time professional staff to allow us to invest in private markets and emerging markets.

The second set has focused on costs by separating alpha and beta assets. QE has helped passive funds by creating a strong upward momentum in the markets. So, our allocation to passives has more than doubled from 16% to 33% in this decade. Our active funds are now confined to private markets and emerging markets, where pricing anomalies still prevail. Growing reliance on passives has also reduced our manager selection costs and enabled us to exploit emerging themes at different phases of the market cycle via ETFs. No doubt, passive funds will be hit hard in the next bear market. But we are raising our holding periods to allow mean reversion to work.

~ A Swiss pension plan

Alignment of interests is the new silver bullet

Alignment is no longer just about fees… but also about investment beliefs and time horizons.

As mentioned in the previous subsection, investing has become a loser's game.

Hence, successful pension plans have adopted a 'physician heal thyself' approach, duly recognising that their own actions can have a big impact on portfolio returns. But because of information asymmetry, they don't know what they don't know.

They have thus adopted a disciplined approach to buying and selling securities, honed by years of experience of what works and what doesn't over various phases of the investment cycle.

Such adaptive learning has also led to refinements in their views about the merits of the different asset manager business models they have been exposed to in the past 20 years.

These models retain their validity. But the deciding criterion now is not so much the nature of the business model but whether the manager in question offers a strong alignment of interests, according to 63% of our respondents (Figure 4.2).

The alignment is no longer just about having fees that offer the equitable sharing of gain and pain with clients, via a well-structured performance fee. It is also about having an alignment of investment beliefs and time horizons (see Insights on next page).

In the past, investment strategies have often come unhinged because pension plans have been unaware of the thinking behind them and also about the expected time horizons over which their returns can realistically materialise.

Unsurprisingly, therefore, 54% of respondents also rank specialised boutique alpha managers as well placed to deliver client needs.

Such managers are perceived as having the deep expertise essential for high-conviction investing; with a strong alignment of

Figure 4.2 **Which asset management business models are most suited to deliver your return expectations?** (Pension plan survey)

Source: Amundi Asset Management/CREATE-Research Survey 2019

Interview quotes

"QE has lifted all asset management business models: the good, the bad and the ugly."

"Managers with an eye for opportunities in distorted markets will be the winners."

Pension investors are keen to be providers of liquidity, instead of its users, in periods of market dislocation.

interest via meritocratic incentives, common investment beliefs and common time horizons – all designed to attract long-term investors. Such managers typically tend to be in partnerships with fewer pressures to deliver quarterly numbers.

Three other models are also viewed favourably: large integrated houses with alpha and beta capabilities (47%), multi-boutique houses with a range of specialisms in separate business units (44%), and providers of customised solutions (41%). Each has strong brands, a long pedigree and pension assets.

However, these models – embracing a multiplicity of capabilities – are no longer perceived as being distinctive in their own right in this decade. This is because QE has had a disproportionate impact on investment returns to the point of overwhelming their inherent strengths – at least for now.

Furthermore, these models have increasingly overlapped as they have evolved. For example, large integrated houses now cover index funds, provide customised solutions and also have 'virtual boutiques' based on product groups.

Thus, pension investors are looking elsewhere for distinctiveness in areas significantly affected by QE – directly and indirectly. One of them is alignment of interest, as previously discussed. There are two others as well.

The first is specialised capabilities in liquidity management (46%). These have come to the fore as the structure of the markets has changed in this decade and pension investors are keen to be providers of liquidity, instead of its users, in periods of market dislocation.

The second area relates to specialised capabilities in private markets (38%). As we saw in Section 3, these have become attractive, as pension investors seek better returns and lower mark-to-market risk in this low return/high volatility era.

Interview quotes

"The demarcation lines between traditional business models are weakening."

"We have often bought assets at the wrong time and sold at the wrong time."

Insights

Financial and non-financial alignment

In the last decade, when selecting external asset managers, the nature of their business model was a material factor. In this decade, as QE has lifted all the boats and distorted the markets, we have shifted emphasis. Alignment of interests is a key swing factor.

Investing is all about buying low and selling high. That sounds simple, but it's not easy. We are in a low return/high volatility era in which we need low-cost market exposure. But our managers like to sell what they have, rather than what we need. Innovations should be demand-led, not supply-led. To ensure that, we now seek financial as well as nonfinancial alignment of interests with our managers. The aim is to move them from being a distant vendor to a thinking partner.

On the financial side, we only pay fees that offer equitable pain and gain with our asset managers, with a clear separation of alpha and beta. Our alpha mandates attract a low base fee plus a performance fee that kicks in only when the fund exceeds the highest previous value reached by its cumulative returns. For certain funds, we pay rolling multi-year performance fees to discourage excessive risk taking to meet a given year's target.

On the non-financial side, we have also sought to align our investment beliefs and time horizon with those of our managers. Recently, some of our active strategies failed as our choices were overly influenced by their past returns. We did not fully understand the beliefs on which they were based, nor the time horizon over which they were expected to deliver. The approach was fraught with 'wrong time' risk and 'regret' risk. We minimise them now via regular engagement with our asset managers.

Such engagement aims to do the following: align beliefs and time horizons; seek a second opinion on our asset allocation; gain deeper insights into what works at different stages of the market cycle; develop the mental agility to capitalise on periodic market dislocations; and minimise herding provoked by periodic volatility.

Indeed, engagement is so essential, as we continue to tilt our portfolio towards ESG, that its success depends upon a high degree of shareholder activism on our part.

~ A French pension plan

Other publications from CREATE-Research

The following reports and numerous articles and papers on the emerging trends in global investments are available free at *www.create-research.co.uk*

- *Future 2024: Future-proofing your asset allocation in the age of mega trends (2019)*
- *Passive investing: The rise of stewardship (2019)*
- *Rocky Road for the European Union: Pension Plans' Response (2018)*
- *Passive investing: Reshaping the global investment landscape (2018)*
- *Alternative investments 3.0 (2018)*
- *Back to long-term investing in the age of geopolitical risk (2017)*
- *Active investing: Shaping its future in a disruptive environment (2017)*
- *Digitisation of asset and wealth management (2017)*
- *Expecting the unexpected: How pension plans are adapting to a post-Brexit world (2016)*
- *Financial Literacy: Smoothing the path to improved retirement savings (2016)*
- *2008: A turning point in the history of investing (2016)*
- *How Pension Plans are Coping with Financial Repression (2015)*
- *Pragmatism Presides, Equities and Opportunism Rise (2015)*
- *Why the Internet Giants Will Not Conquer Asset Management (2015)*
- *Pension Dynamics: The Impact of the End of Compulsory Annuitisation in the UK (2015)*
- *Alpha behind Alpha: Rebooting the pension business models (2014)*
- *Not All Emerging Markets Are Created Equal (2014)*
- *Investing in a High Frequency Trading Environment (2014)*
- *Upping the Innovation Game in a Winner Takes All World (2013)*
- *A 360-Degree Approach to Preparing for Retirement (2013)*
- *Investing in a Debt-Fuelled World (2013)*
- *Market Volatility: Friend or Foe? (2012)*
- *Innovations in the Age of Volatility (2012)*
- *The Death of Common Sense: How Elegant Theories Contributed to the 2008 Market Collapse? (2012)*
- *Investment Innovations: Raising the Bar (2011)*
- *Exploiting Uncertainty in Investment Markets (2010)*
- *Future of Investments: the next move? (2009)*
- *DB & DC plans: Strengthening their delivery (2008)*
- *Global fund distribution: Bridging new frontiers (2008)*
- *Globalisation of Funds: Challenges and Opportunities (2007)*
- *Convergence and divergence between alternatives and long only funds (2007)*
- *Towards enhanced business governance (2006)*
- *Tomorrow's products for tomorrow's clients (2006)*
- *Comply and prosper: A risk-based approach to regulation (2006)*
- *Hedge funds: a catalyst reshaping global investment (2005)*
- *Raising the performance bar (2004)*
- *Revolutionary shifts, evolutionary responses (2003)*
- *Harnessing creativity to improve the bottom line (2001)*
- *Tomorrow's organisation: new mind-sets, new skills (2001)*
- *Fund management: new skills for a new age (2000)*
- *Good practices in knowledge creation and exchange (1999)*
- *Competing through skills (1999)*
- *Leading People (1996)*

Prof. Amin Rajan

amin.rajan@create-research.co.uk

Telephone: +44 (0) 1892 784 846
Mobile/Cell: +44 (0) 7703 44 47 70

Amundi
ASSET MANAGEMENT

create

Amundi is Europe's largest asset manager by assets under management and ranks in the top 10[1] globally. It manages 1,487 billion[2] euros of assets across six main investment hubs[3]. Amundi offers its clients in Europe, Asia-Pacific, the Middle East and the Americas a wealth of market expertise and a full range of capabilities across the active, passive and real assets investment universes. Clients also have access to a complete set of services and tools. Headquartered in Paris, Amundi was listed in November 2015.

Thanks to its unique research capabilities and the skills of close to 4,500 team members and market experts based in 37 countries, Amundi provides retail, institutional and corporate clients with innovative investment strategies and solutions tailored to their needs, targeted outcomes and risk profiles.

Amundi. Confidence must be earned.

Visit amundi.com for more information or to find an Amundi office near you.

Follow us on

[1] Source IPE "Top 400 asset managers" published in June 2019 and based on AUM as of end December 2018

[2] Amundi figures as of June 30, 2019

[3] Investment hubs: Boston, Dublin, London, Milan, Paris and Tokyo

CREATE-Research is an independent research boutique specialising in strategic change and the newly emerging business models in global asset management. It undertakes major research assignments from prominent financial institutions and global companies. It works closely with senior decision makers in reputable organizations across Europe and North America.

Its work is disseminated through high profile reports and events which attract wide attention in the media. Further information can be found at www.create-research.co.uk

The information contained in this document is deemed accurate as of 01 November 2019. Data, opinions and estimates may be changed without notice.

In the European Union, this document is only for the attention of "Professional" investor as defined in Directive 2004/39/EC dated 21 April 2004 on markets in financial instruments ("MIFID"), to investment services providers and any other professional of the financial industry, and as the case may be in each local regulations and, as far as the offering in Switzerland is concerned, a "Qualified Investor" within the meaning of the provisions of the Swiss Collective Investment Schemes Act of 23 June 2006 (CISA), the Swiss Collective Investment Schemes Ordinance of 22 November 2006 (CISO) and the FINMA's Circular 08/8 on Public Advertising under the Collective Investment Schemes legislation of 20 November 2008. In no event may this material be distributed in the European Union to non "Professional" investors as defined in the MIFID or in each local regulation, or in Switzerland to investors who do not comply with the definition of "qualified investors" as defined in the applicable legislation and regulation. This document neither constitutes an offer to buy nor a solicitation to sell a product, and shall not be considered as an unlawful solicitation or an investment advice. Amundi accepts no liability whatsoever, whether direct or indirect, that may arise from the use of information contained in this material. Amundi can in no way be held responsible for any decision or investment made on the basis of information contained in this material. The information contained in this document is disclosed to you on a confidential basis and shall not be copied, reproduced, modified, translated or distributed without the prior written approval of Amundi, to any third person or entity in any country or jurisdiction which would subject Amundi or any of "the Funds", to any registration requirements within these jurisdictions or where it might be considered as unlawful. Accordingly, this material is for distribution solely in jurisdictions where permitted and to persons who may receive it without breaching applicable legal or regulatory requirements. The information contained in this document is deemed accurate as at the date of publication set out on the last page of this document. Data, opinions and estimates may be changed without notice. You have the right to receive information about the personal information we hold on you. You can obtain a copy of the information we hold on you by sending an email to info@amundi.com. If you are concerned that any of the information we hold on you is incorrect, please contact us at info@amundi.com. Document issued by Amundi, a société anonyme with a share capital of 1 086 262 605 € – Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris

www.amundi.com