Quarterly Pensions Investments Review

Expected Investment Performance - Q1 2024

Introduction

The Quarterly Pensions Investments Review is a comparison in expected risk and return investment.

Key Findings

- **Comparing pension funds and regions:** expected returns of UK pension plans outperform those of their mainland Europe counterparts. This is driven by their high exposure to bonds and inflation-linked bonds, which are expected to perform well as interest rates somewhat decline and stabilize in our forecast.
- **Comparing quarter on quarter:** overall expected returns slightly decline after a quarter of strong realized returns, as inflation turned out to be stickier than anticipated. While the bond outlook improved with higher long rates, this is not sufficient to offset lower expected equity returns.
- For details, please see below

If you're interested in learning how your pension fund is performing relative to others, please contact us for more information.

Expected Investment Performance – Risk and Return Results

The charts below show the expected investment return vs. the expected investment risk - from the top 30 largest pension funds per region.

Comparing pension funds and regions

Looking at general trends, the difference in expected returns between regions is stark. Expected returns and volatility among pension plans in North America and the UK are relatively high, while pension plans in Switzerland and the Netherlands show more moderate expectations.

This quarter we focus our attention on the UK.

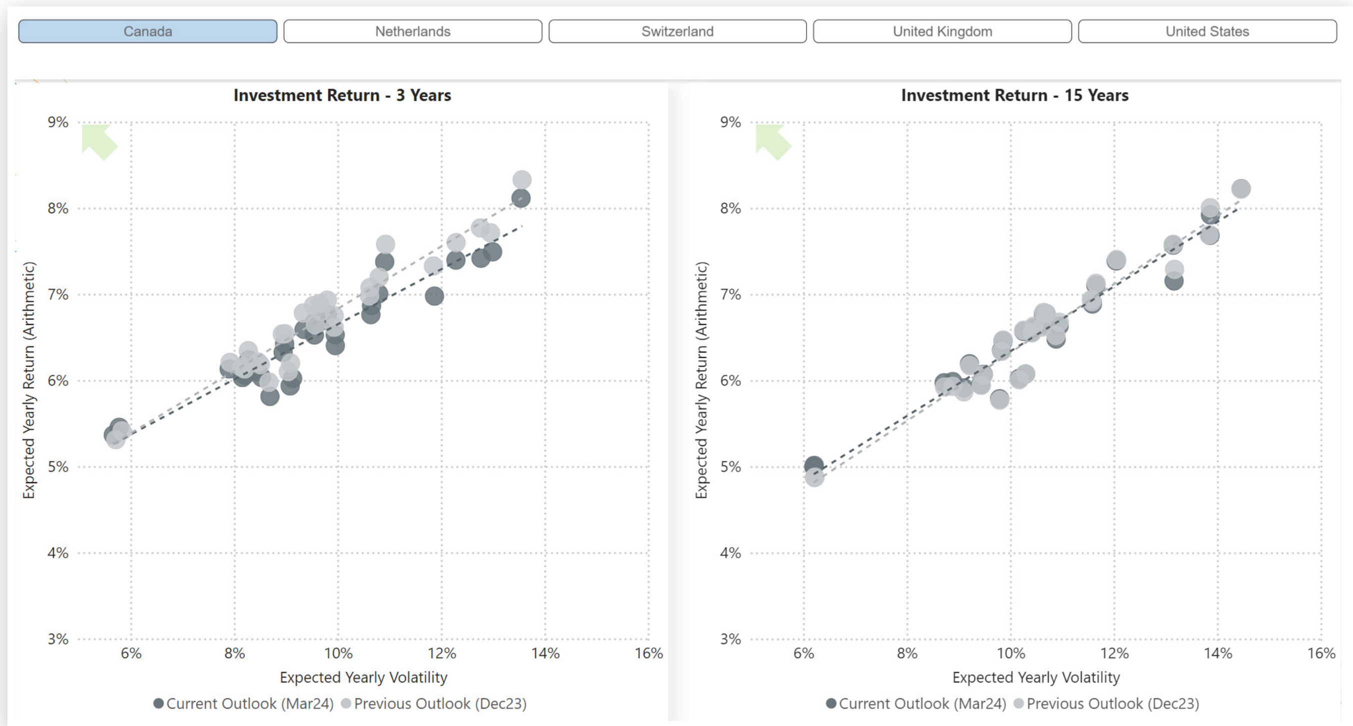
The UK pensions schemes have long been an implementer of the LDI strategy, including the use of swap products to reduce any funding risks stemming from changes in liability value. At times, individual funds could be 100% hedged on both an inflation and interest rate basis. This has quite a significant impact on returns as these swap products mimic the return on liabilities. Given that the QPIR is an asset-only analysis, the impact of the LDI strategy is not taken into account in the charts, however, it does offer a high-level indication of the different regional biases when constructing portfolios.

The chart shows that the majority of UK pension plans have an expected return of around 6.25%, higher than most regions. These funds favor a substantial portion of their investments in fixed-income instruments, such as nominal and index-linked government bonds. On average, the top 30 UK pension funds have over 30% allocated to these bonds, with two-thirds (20%) being in index-linked, double that of the US and Canada. This strategy aligns with regulatory directives, as both private and public plans are mandated to utilize yields from UK government securities when discounting their liabilities, while small adjustments can be made for broader economic factors such as economic growth and wage inflation. By allocating to government bonds, there is a natural hedge against movements stemming from the liability value. In contrast to the US, UK pension schemes have less leeway in selecting a discount rate, highlighting a more standardized approach within the regulatory framework.

Moreover, indexation is guaranteed in the UK, meaning that liability values rise in tandem with realized inflation, subject to caps or floors. This feature introduces significant inflation risk, which is not necessarily present in other regions, like the. Netherlands. To mitigate this risk, UK pension funds allocate a considerable portion to index-linked bonds, providing a natural hedge against inflationary pressures. This strategic allocation underscores the proactive measures taken by UK pension funds to safeguard against inflation-related uncertainties, thus enhancing the long-term stability and resilience of their portfolios.

As the allocation to government and index linked bonds are relatively high, the 6.25% return is somewhat overstated given the expected interest rate decline forecasted in our output. Therefore, in the coming quarters, as declining interest rates stabilize, the expected return for the UK pension plans are likely to become more neutral and follow a similar path to the Netherlands (~5.5%). We have already seen it drop from c.6.5% compared to our Dec 2023 forecasts.

Comparing quarter on quarter



Market developments and other events

At the start of the year, US financial markets expected inflation to fall rapidly and the US Fed to introduce rate cuts by the end of the quarter. However, inflation turned out to be stickier than anticipated, only decreasing marginally. In response, most central bank refrained from interest rate cuts sending long interest rates higher.

There are exceptions. The Swiss National Bank unexpectedly lowered its policy rate stating that their anti-inflationary policy is paying off. Additionally, the Bank of Japan increased policy rates and brought an end to 17 years of negative rates as inflation seems to stabilize above target.

The US economy, once again, proved to be more resilient than anticipated with higher-than-expected growth for 2023 Q4 while producer sentiment remained in expansionary territory. In Europe, growth remained muted but early signs of recovery emerged as indicators on services and manufacturing activity picked up. Although Chinese economic activity remained sluggish, manufacturing activity seems to be stabilizing.

Strong economic data, robust corporate earnings, and enthusiasm on AI developments resulted in gains for developed market equities and decreasing credit spreads. The broad commodity market saw gains in both energy prices and precious metals. More specifically, gold prices reached all-time highs amid ongoing supply cuts raised tensions in the Middle East.

Despite tight monetary policy, a soft landing is almost within reach for the US where inflation continues to moderate with limited job losses and resilient growth. Although economic growth is more muted in the rest of the world, global labor markets remained relatively robust suggesting that the economic damage resulting from the extraordinary spike in global inflation was contained.

In line with a relatively flat but positive medium-term economic prospects, the GDP growth outlook is expected to improve from current levels for the UK and Europe and normalize from recent economic tailwinds for the US. This aligns with major central banks carefully upgrading their cumulative growth forecast for 2026.

Tight financial conditions and moderate growth prospects suggest that core inflation will decline in the coming years. At the same time, it is expected that (core) inflation gradually converges towards central bank targets in the coming 5 years.

Long-term interest rates are expected to slightly decrease but move around current levels in line with expected declining inflation and moderate growth prospects over the medium term. Short-term interest rates are expected to decline in line with continued forward guidance on prospective monetary easing.

Outlook for financial assets

Positive market sentiment, slowing inflation, and better than expected growth lift the economic cycle into positive territory. The economic cycle is expected to move close to its neutral level for the coming years as economic conditions are normalizing with inflation slowly trending down.

Compared to 2023 Q4, the short-term equity outlook slightly deteriorates reflecting the strong past quarter for equities. Nonetheless, equity returns remain positive over the next twelve months, despite somewhat stretched equity valuations with some investable regional benchmarks reaching historic highs. The medium-term equity outlook slightly deteriorates as economic prospects weaken.

The government bond return outlook improves as postponed policy rate cuts and continued economic resilience sent long rates higher. The HY and IG corporate credits return outlook worsened on a one-year horizon following lower initial credit spreads as economic conditions improved. The IG credit return outlook improves on a 3-5 year horizon following higher expected government bond returns.

The outlook for financial assets remains clouded by elevated volatility and downside risk due to tight financial conditions and elevated geopolitical tensions of the ongoing war in the Middle East and Ukraine.

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Methodology and assumptions

This analysis is based on publicly available data, such as investment policy statements and annual reports, from the top 30 largest pension funds in Canada, the Netherlands, Switzerland, the UK, and the US.

The projections are made with GLASS Ortec Finance's GLASS, a forward-looking Asset-Liability Management platform for institutional investors. Plan modeling is based on strategic asset allocations, mapped to public and private benchmarks, and rebalanced annually. For simplicity, active hedging strategies and derivatives are not included in the Quarterly Pension Review.

Returns shown are gross of management fees and expressed in the local currency of the relevant country.

The projections in this analysis are driven by the Ortec Finance Economic Scenario Generator.

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More information?

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