Quarterly Pensions Investments Review

Expected Investment Performance - Q2 2024

Introduction

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

Key Findings

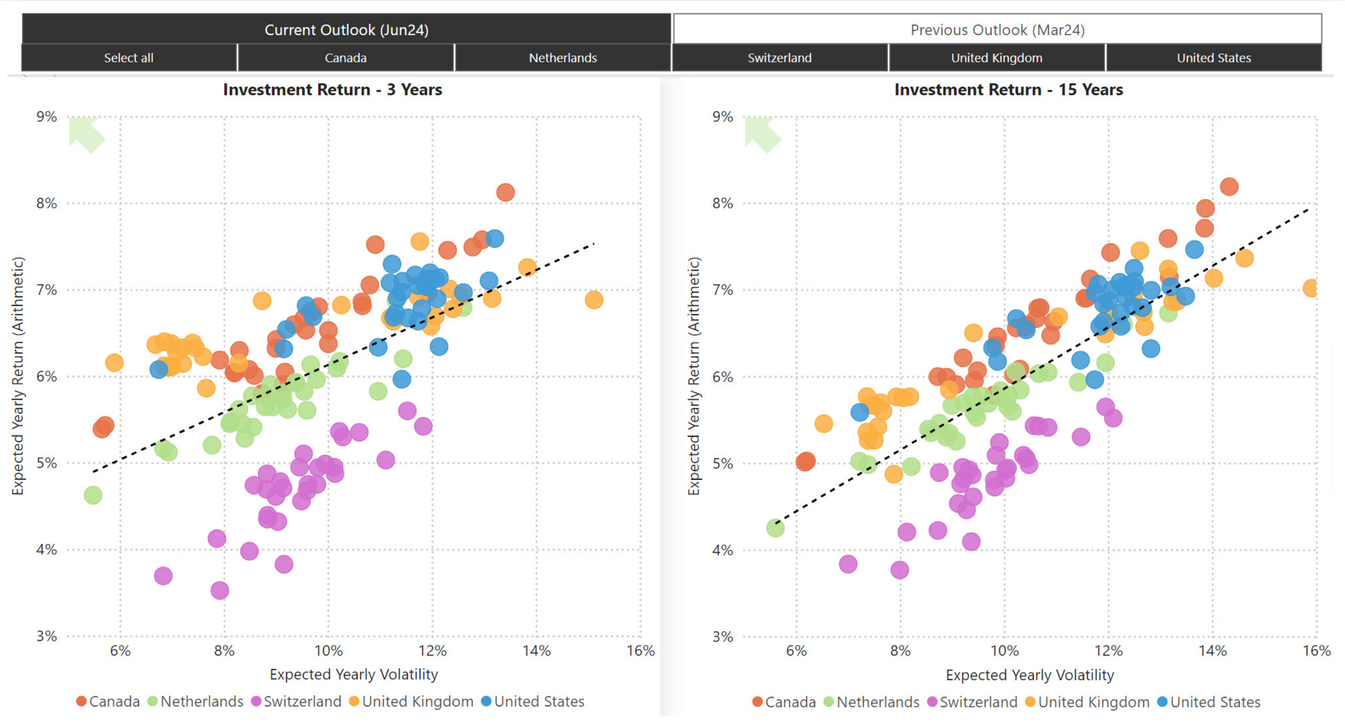
- **Comparing pension funds and regions:** Given the low, fixed and sticky discount rate for Swiss pension funds, there is no immediate need to construct high returning risky portfolio. This leads to fund returns in Switzerland being lower than other regions.
- **Comparing quarter on quarter:** Overall, the bond return outlook improves somewhat on (marginally) higher yields. On the other hand, the (short-term) equity outlook slightly deteriorates, due to already positive realized equity returns. European and UK equities are an exception as they are anticipated to rebound on June's weak performance.
- 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



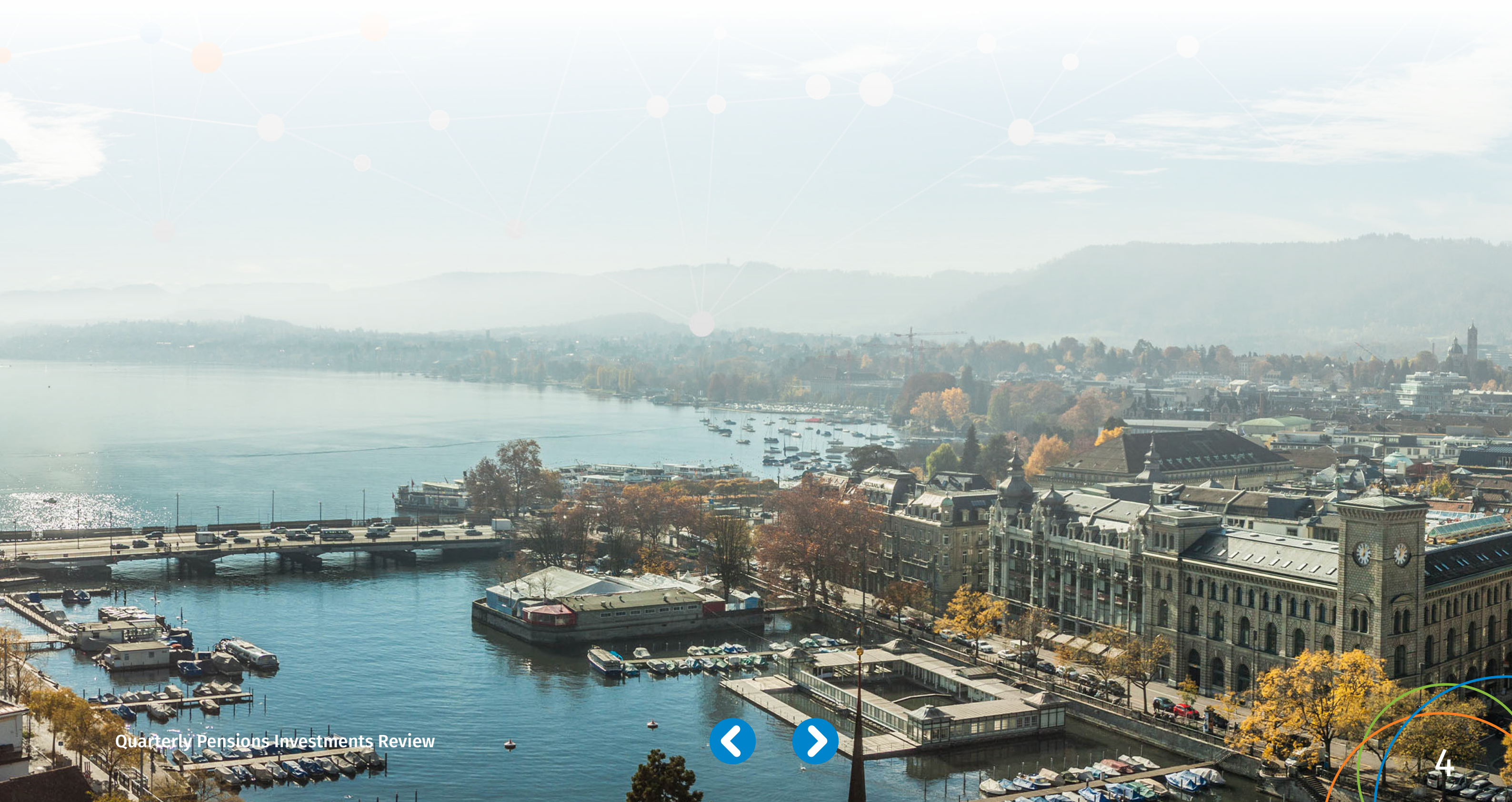
Looking at general trends, the difference in expected returns between regions is stark. Expected returns and volatility among pension plans in North America and the UK are relatively high, while pension plans in Switzerland and the Netherlands show more moderate expectations.

This quarter we focus our attention on Switzerland.

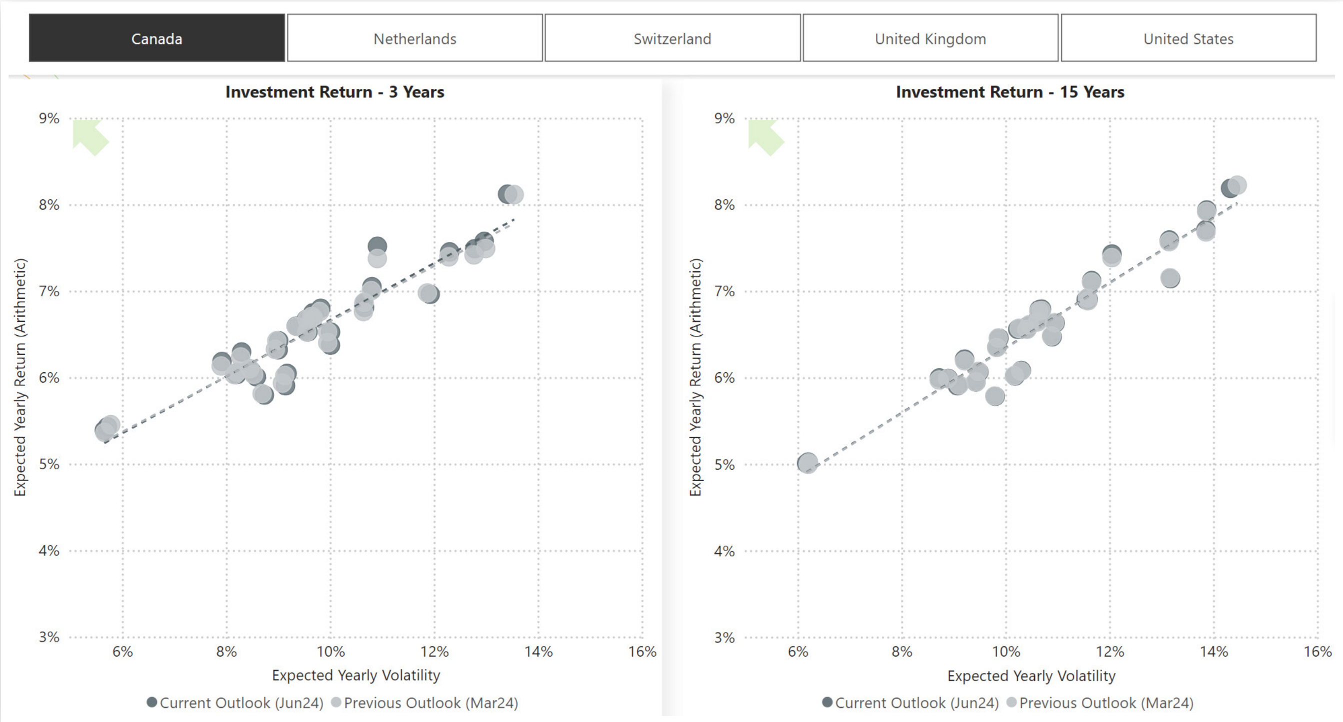
The chart shows that the Swiss pension funds are grouped along a relatively low expected return of just below 5%. In Switzerland, funds use a fixed discount rate, which hover between 0.5% - 2%, significantly lower than other regions. This feature is a predominant driver of the strategy employed on the asset side of the balance sheet. The low discount rate means there is a lower hurdle for assets to outperform liabilities, and therefore no immediate need to construct high returning risky portfolios, opposite to regions like the US. The fixed component leads to there being no interest rate sensitivity in the liability valuation thus reducing the need to incorporate significant portions to fixed income, unlike regions like the UK and NL where a matching portfolio is common practice. One reason for this fixed and static discount rate relates to the structure of the benefit payments. In Switzerland, the DB schemes have a cash balance plan where at retirement the savings are transformed into an annuity which is calculated on a fixed conversion rate. Given the link between conversion rate and the liability discount rate, any adjustments made to the discount rate would impact the attractiveness of the final annuity for pensioner. Any adjustment to the conversion rate is political and a lengthy process to change, therefore these parameters tend to remain sticky.

Beyond this, the Swiss funds have a significant home bias with approximately 70%, 30% and 95% of fixed income, equity and real estate portfolios invested in Swiss products, whilst they are well diversified in the alternatives space. Due to the low required return and the high hedging costs, an international asset class will need to be significantly more attractive for the funds to consider investing. In terms of asset classes, allocation to real estate is significantly higher than other regions (20% vs 9.3% on average) mainly driven by the very stable Swiss real estate market as shown by the near perfect diagonal trend in the KGAST Immo-Index. Since the liabilities are not sensitive to interest rates, real estate serves as a great defensive asset with higher yields than traditional fixed income products.

So, taking all into account, given the low, fixed and sticky discount rate, there is no immediate need to construct high returning risky portfolios. This leads to fund returns in Switzerland being lower than other regions.



Comparing quarter on quarter



Market developments and other events

Despite moderate GDP growth for most regions, long rates increased amid continued inflation concerns prompting major central banks to remain cautious. Headline inflation declined as food and goods inflation moderated, while services inflation remained elevated suggesting core inflation remains sticky and above central bank target in the short term. The ECB cut interest rates but revised their inflation forecast upwards citing high labor costs, while the US Federal reserve and the Bank of England maintained rates at current levels.

The US economy grew less than anticipated in the first quarter and economic indicators pointed towards further slowdown as retail spending cooled, unemployment edged up slightly and real wage growth slowed. First quarter data showed that the EU and UK returned to growth, showing some positive momentum. Overall, global economic prospects seem to be converging towards moderate growth.

Most developed market equities performed well, buoyed by continued AI enthusiasm. United States equities reached record highs, but European equites underperformed due to increased political uncertainty associated with the snap elections in France. Emerging market equities outperformed, owing to improving growth prospects in China and India. Oil prices surged in June after OPEC+ announced production cuts in response to earlier concerns about slowing oil demand.

Outlook for growth, inflation, and interest rates

Some signs point towards a soft-landing scenario as inflation gradually declines and growth in developed economies converges to moderate levels. Global labor markets are showing signs of cooling from historically tight levels but remain relatively robust, suggesting that the damage from the extraordinary spike in global inflation remains contained.

Short-term growth prospects in developed economies remain moderate amid cooling labor markets and above-trend interest rates. In the medium term, growth prospects are expected to slightly improve as the global economy moves on past the peak of monetary tightening.

Tight financial conditions and moderate growth prospects suggest that core inflation will decline in the coming years. Nevertheless, in the medium term (core) inflation is expected to slowly converge towards target against the background of upward fiscal spending pressures associated with the energy transition and elevated geopolitical risks.

Long-term interest rates are expected to move around their recent levels or somewhat decline for most developed markets in the medium term. This reflects higher for longer dynamics as inflation is anticipated to slowly converge to target.

Outlook for financial assets

Slightly higher global unemployment, along with negative market sentiment surrounding political uncertainty in Europe, weigh on the economic cycle. Nevertheless, the economic outlook remains stable as economic conditions are normalizing with inflation slowly trending down.

Equity returns remain positive over the next twelve months, despite somewhat stretched equity valuations. Compared to the first quarter, the short-term equity outlook slightly deteriorates, due to already positive realized equity returns. European and UK equities are an exception as they are anticipated to rebound on June's weak performance.

The medium-term government bond return outlook for developed markets improves on higher expected yields. The HY and IG corporate credits return outlook also improves for most countries, following higher expected government bond yields.

The outlook for financial assets remains clouded by elevated volatility and downside risk due to tight financial conditions, political uncertainty and elevated geopolitical tensions as signified by the ongoing wars in the Middle East and Ukraine.

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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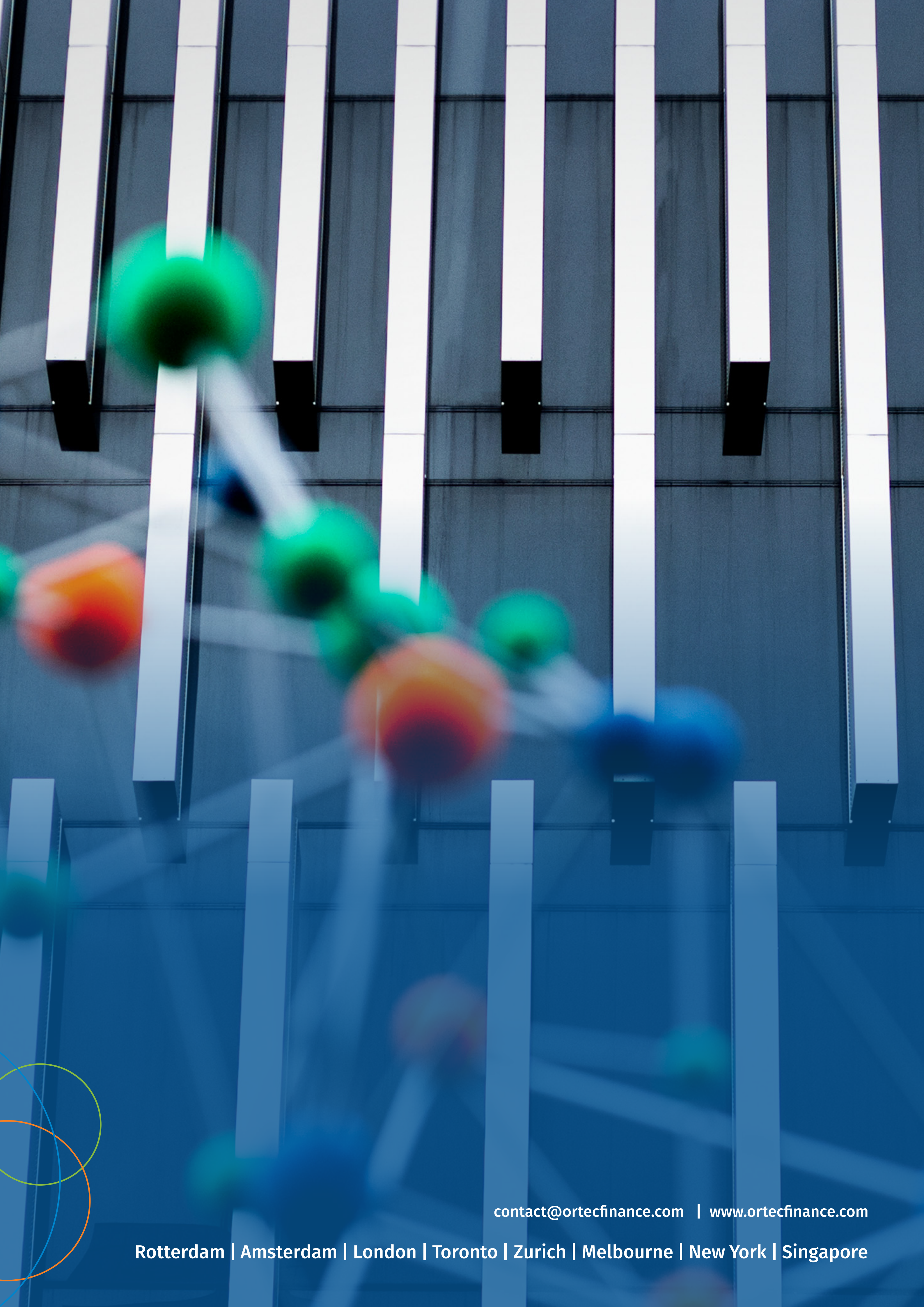

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