ORTEC FINANCE

Quarterly Pensions Investments Review

Expected Investment Performance - Q3 2024

Introduction

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

Key Findings

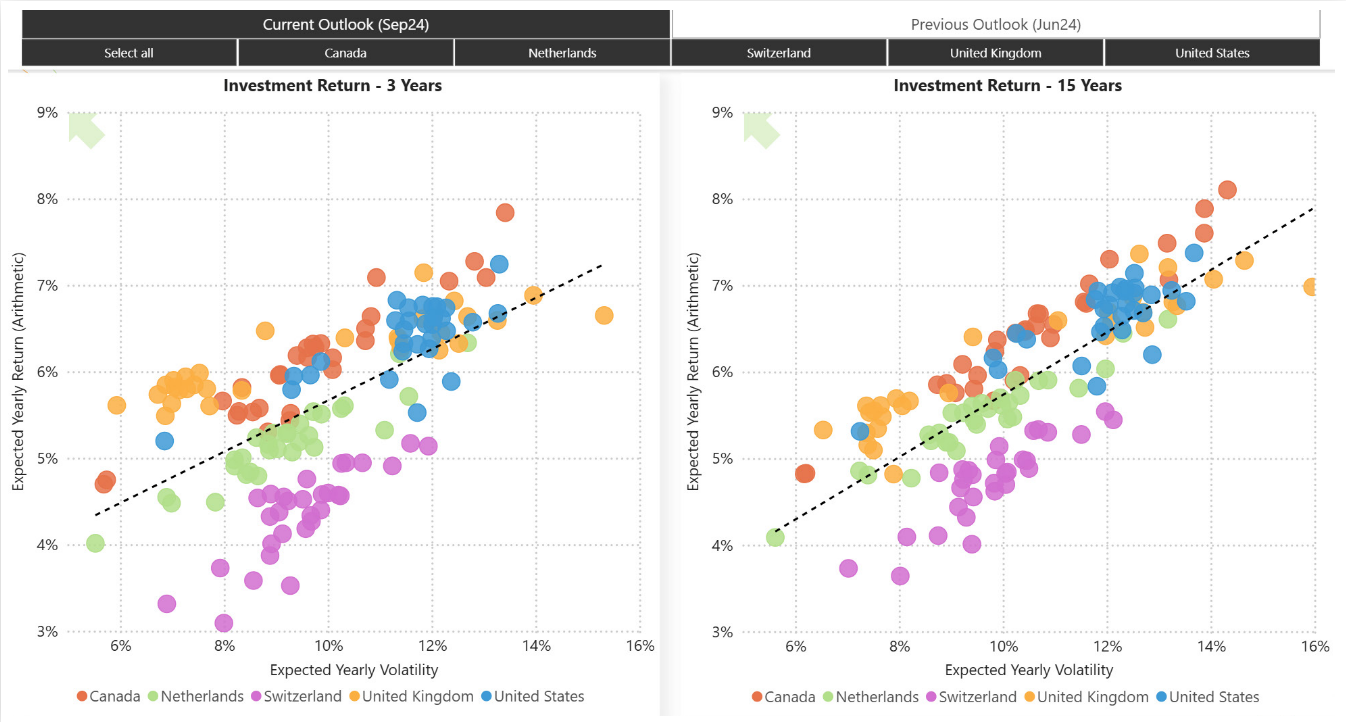
- **Comparing pension funds and regions:** The combination of market-sensitive discount rates and conditional indexation makes Dutch pension fund investing more conservative compared to other regions (especially North America), resulting in moderate returns but stronger protection against liability volatility.
- **Comparing quarter on quarter:** Overall, the return outlook for government bonds and corporate credits weakens due to declining yields amid continued progress on disinflation. On the other hand, the short-term one-year equity outlook has slightly improved due to anticipated further easing of financial conditions.
- 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 Netherlands.

The Dutch pension system is known for its robust structure and significant allocation to fixed income. This is largely driven by conditional indexation (cost of living adjustments) and the market-sensitive discount curve used to value liabilities.

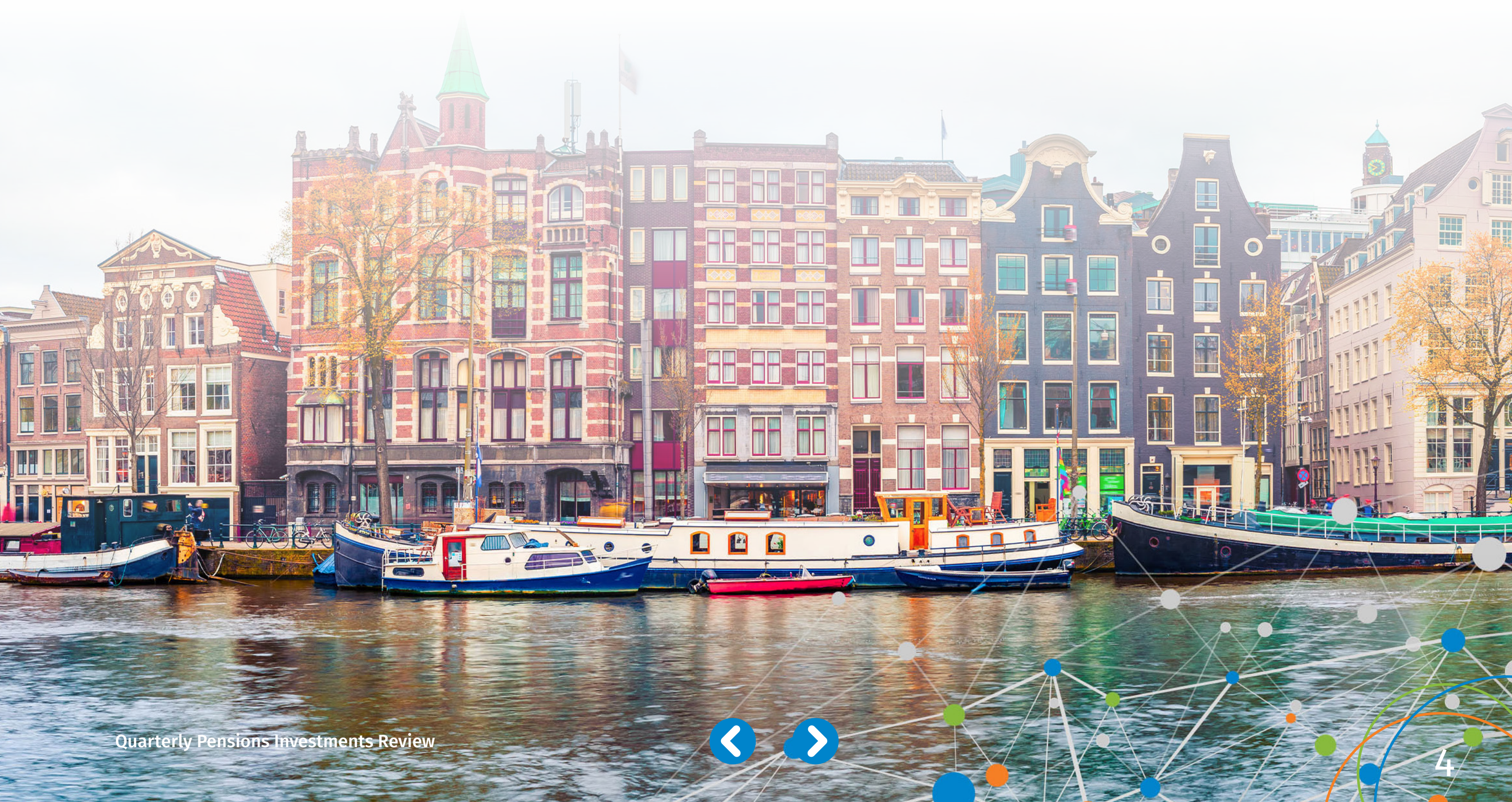
Unlike some other regions, such as the United States, pension funds in the Netherlands do not employ a fixed or expected return discount rate; instead, they value their liabilities based on market rates, using an ultimate forward rate methodology established by the Dutch central bank. The to changing interest rates requires Dutch funds to maintain substantial allocations to fixed income and swaps to hedge against interest rate risk and ensure stable funding levels.

As shown in the scatterplot, Dutch pension funds exhibit lower expected yearly returns (of around 5-6%) when compared to North American funds, which are driven by more aggressive asset allocations. The Dutch focus on liability-driven investment strategies leads to a more conservative asset mix, with higher proportions of bonds held to match liabilities and reduce funding ratio volatility.

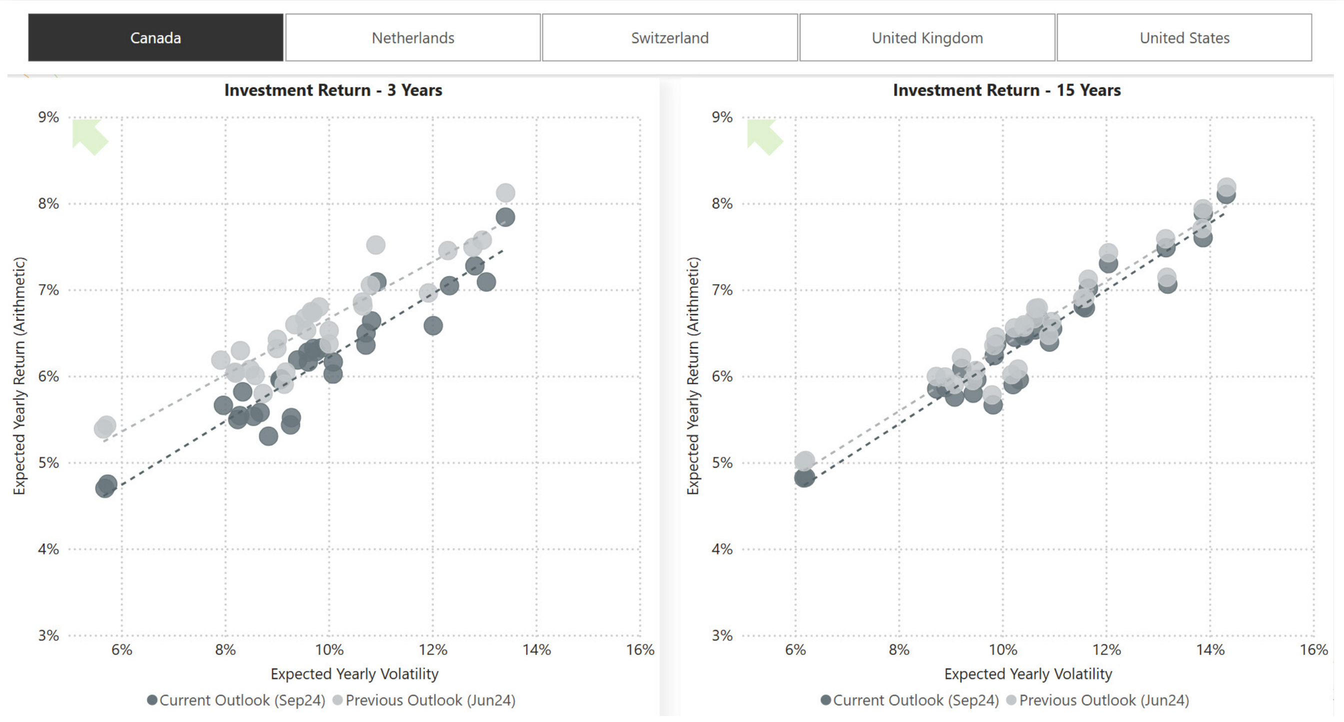
Additionally, the conditional indexation in the Netherlands means that pension increases depend on the financial health of the pension fund. If funding ratios fall below a certain threshold, indexation can be halted, incentivizing funds to adopt a risk-averse investment approach to avoid underfunding. Moreover, benefits can be cut as well.

In summary, the combination of market-sensitive discount rates and conditional indexation makes Dutch pension fund investing more conservative compared to other regions (especially North America), resulting in moderate returns but stronger protection against liability volatility.

Finally, please note that the Dutch pension system is transitioning from traditional defined benefit (DB) schemes to a more defined contribution (DC) type of scheme. This shift is not yet reflected in current investments but will play a significant role in the coming years.



Comparing quarter on quarter



Market developments and other events

Growth is moderating, and inflationary pressures have eased in major economies, although core inflation remains sticky in most regions. Most major central banks implemented their first rate cuts, signaling increasing confidence in sustained disinflation. In combination with signs of moderating economic growth, capital markets significantly lowered their interest rate expectations.

The Bank of Japan hiked rates, triggering significant market turbulence and a strengthening of the yen in August. The BoJ signaled its commitment to its long-term plan to raise rates due to ongoing inflationary pressures, while accounting for the yen's volatility and its impact on inflation.

Despite early bursts of volatility due to concerns about slowing but persistent economic growth, global equities and corporate credits performed well amid growing confidence in further monetary easing. Emerging equities outperformed other regions as China unveiled a broad stimulus package to boost its economy.

Commodity price performance was mixed, with precious metals continuing to rise and energy prices falling amid growth concerns in the US and China.

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 have shown 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 past the peak of monetary tightening and into easing financial conditions.

In the medium term, inflation is expected to stabilize somewhat above central bank targets, partly due to anticipated upward fiscal pressures associated with the energy transition and elevated geopolitical risks. Additionally, supply-side factors such as lower global trade integration, aging populations, and the energy transition could continue to contribute to ongoing upward inflationary pressure.

For the coming years, long-term rates are expected to move around their recent levels or slightly decline in most developed markets. This reflects a "higher for longer" dynamic, as inflation is anticipated to gradually converge to target. Short-term interest rates are expected to decline, consistent with continued forward guidance on prospective monetary easing.

Outlook for financial assets

The current economic cycle is deteriorating as lower interest rates are counterbalanced by increased capital market volatility. Nevertheless, the outlook remains stable as economic conditions normalize and inflation trends downward.

Compared to the previous quarter, the short-term equity outlook has slightly improved due to anticipated further easing of financial conditions. Accordingly, equity returns are expected to remain positive over the next twelve months, despite somewhat stretched equity valuations.

The return outlook for government bonds and corporate credits weakens due to declining yields amid continued progress on disinflation.

The overall outlook for financial assets remains clouded by elevated volatility and downside risks, driven by above-trend interest rates and heightened geopolitical tensions. For example, further escalation of the conflict in the Middle East, potentially escalating into a full-scale regional war, presents significant downside risks to the outlook.

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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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