

Pension portfolios recalibrating on fears of stagflation

- Inflation will remain structurally higher, with a 1970s-style stagflation anticipated over the next three years.
- Pension plans will target real assets in private markets for inflation protection, and global equities for total returns
- Active investing will be back in focus amid higher dispersion in financial markets, while passive investing will remain critical for cost efficiency in a world of low returns

London, 7 December 2022 – Central banks have been raising interest rates rapidly in response to rampant price pressures. But despite their efforts, inflation is likely here to stay. This underscores the need for pension plans to build inflation resilient portfolios, according to a new report published today by CREATE-Research and the largest European asset manager, Amundi.

The survey is based on responses from 152 pension plans from 17 jurisdictions, managing €1.98 trillion of assets. It aims to shed light on how pension plans are responding, as their portfolios are hit by the market impact of the latest surge in inflation.

The spectre of ‘stagflation’ implies an environment of low returns

When asked about the most likely scenario for the post-pandemic global economy, 50% of survey participants subscribe to a ‘stagflation’ scenario: too hot in terms of inflation and too cold in terms of growth.

The ‘secular stagnation’ scenario is cited by 38%. It envisages a return to the pre-pandemic environment: low growth, low inflation, low physical investment, rampant inequalities and stagnant real wages.

Only 12% anticipate the ‘roaring twenties’ scenario. In it, price pressures from the supply bottlenecks ease notably alongside robust growth, driven by productivity gains from innovation that also keeps inflation low.

Professor Amin Rajan of CREATE-Research, who led the project, said: *“After a prolonged era of cheap money and double-digit returns, the sharp spike in inflation to its 40-year high in 2022 in the West marked a watershed. The key question for pension funds is how to redesign their portfolios in a world of structurally higher inflation, less accommodative central bank policy and higher geopolitical uncertainty.”*

Rising correlations are a game changer

Diversification has once again failed when most needed. Major selloffs in stocks and bonds have moved in lockstep in 2022. Equity / bond correlation turned positive in the phase of rising inflation. It should move back in negative territory along with normalization of inflation, but some instability will persist driving shift in asset allocation.

The first will favour inflation protection assets, mostly in private markets, with around one in every two survey participants increasing allocations to real estate and infrastructure.

The second will intensify the search for better returns as major market moves create distressed asset bargains, with one survey participant claiming, *“bond markets are likely to throw up good buying opportunities with ‘fallen angels’.”* Portfolio flexibility and dry powder will drive dynamic investing redrawing the traditional 60:40 approach, according to 58%.

The third shift envisages greater regional diversification as key markets become desynchronised due to differences in inflation outlooks. 43% of pension plans expect to increase their weighting to developed markets, while 40% prefer emerging markets. The rise of China as an economic superpower becomes a key theme to play as a standalone portfolio allocation.

The final shift centres around the revival of value investing. With high correlations between equities and bonds, 42% believe diversification based on risk factors will gain traction again.

Monica Defend, Head of the Amundi Institute, highlights: *“Monetary policy tightening and the risk of economic recession means financial markets have become very volatile, including traditional safe assets. The traditional 60/40 portfolio needs to incorporate new features, such as higher structural inflation, less accommodative central banks, economic fragmentation, and emerging long term themes like industrial transformation, value chain reshaping, and strategic autonomy. In this respect, high dividend equities, thematic investing and real assets become crucial.”*

Global equities will be the growth engine for portfolios

Only 11% of survey participants believe that the impact of inflation on their investment portfolio will be positive while 59% say it will be negative. As for asset returns over the next three years, 59% believe that they will be far lower than in the last decade. Therefore, asset allocation now has three buckets, each with its own distinct goal: decent total returns, inflation protection and capital conservation.

70% consider global equities the key growth engine for portfolios and the asset class most suited to delivering decent total returns (so long as inflation does not persist above 5%).

For inflation protection, plans are re-orientating towards real assets in private markets, in particular real estate (49%) and infrastructure (49%). However, this is not without its challenges given the limited capacity of such assets and their inherent illiquidity which reduces portfolio flexibility.

Half of respondents (44%) prefer US government bonds as a hedge against risky assets, followed by European government bonds (40%) and Chinese government bonds (36%).

A return to fundamentals will favour thematic funds

As a global recession looms and central banks withdraw liquidity, the search for predictable sources of value creation has intensified. The spotlight is on sectors that are being reshaped by life-changing megatrends that are driving disruptive innovations, transforming business models and reshaping public and corporate policies.

46% of survey participants expect a thematic premium in the post-pandemic world to a large extent, and a further 35% expect it to some extent. As a result, 60% expect to increase their allocations to thematic funds.

With regards to specific themes, Environmental, Social and Governance tops the list and is favoured by 76% of respondents. Other noteworthy themes are Healthcare/Health Tech (50%), Genomics and Biotechnology (32%), and Ageing Societies (38%). Here, the focus is on speeding up medical discoveries and commercialising them quickly, as happened with the Covid-19 vaccine.

Passive and active funds will complement each other

After over a decade of strong tailwinds, passives appear to have retained distinct attractions for pension plans in today's turbulent markets. Key attributes include lower cost (86%), their role as an effective liquidity and hedging tool (56%) and as international diversifiers with key capital markets desynchronised (49%).

However, in investing, there are no all-weather funds and passives are no exception. They have thrived in the unique environment of zero-bound interest rates for the past 13 years. Now, rates are on the rise and the role of central banks in propping up markets is waning. Some limits emerge for passive investment in the survey, as participants believe passive rely too heavily on yesterday's winners and tend to overinflate valuations.

Hence, the environment is turning positive for active managers. Additionally, as central bank support shifts down a gear, market prices are likely to reconnect with their fundamentals and favour active management. Prices of index components are no longer moving in lockstep, thus creating opportunities for active managers to outperform through stock picking.

However, 52% see actives and passives as complementing each other in a diversified portfolio

Taking a forward view, 29% expect to increase their share of passives, 16% expect to decrease it, and the remaining 55% expect the share to remain static.

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¹ Source: IPE "Top 500 Asset Managers" published in June 2022, based on assets under management as at 31/12/2021

² Boston, Dublin, London, Milan, Paris and Tokyo

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³ Amundi data as at 30/09/2022