Allocation changes in institutional portfolios in a low rate environment

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Pension funds' investment objectives Finnish pension system as an example

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Overview – some key characters of the framework

- Defined benefit
  - Size of the benefit agreed => payments adjusted if needed
  - No investment risk assumed by the beneficiary

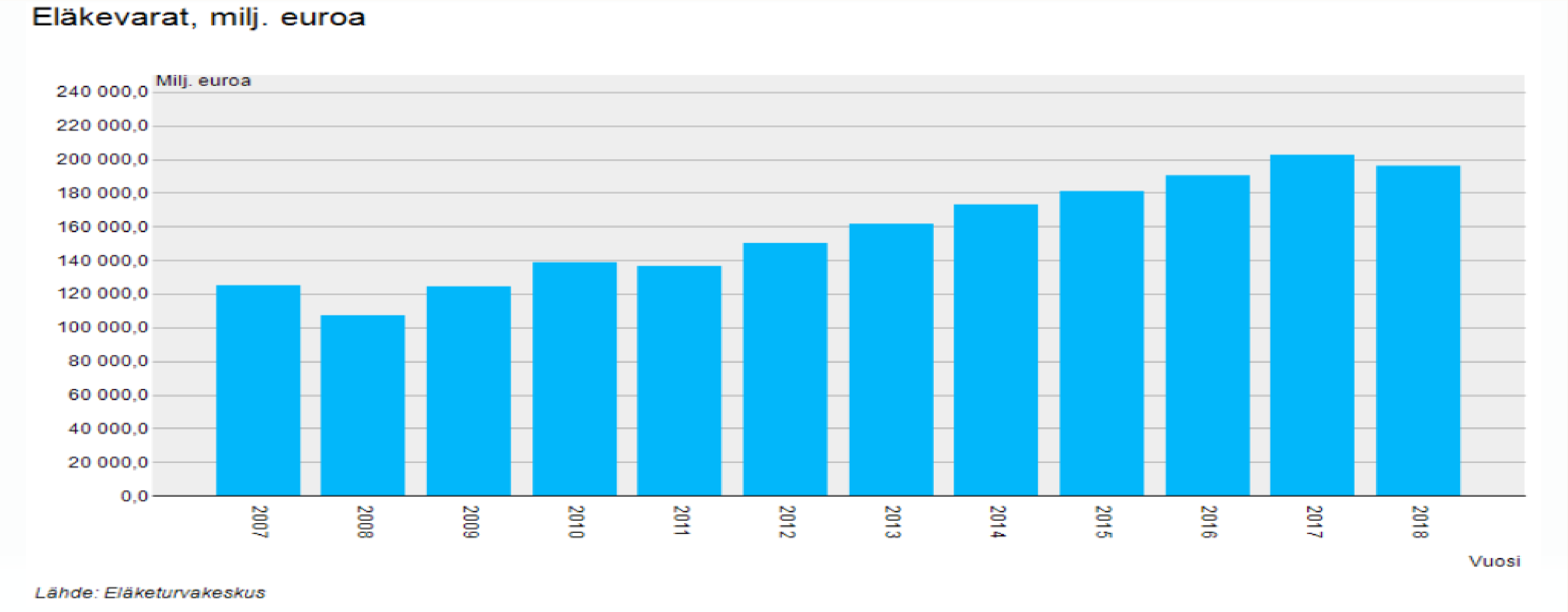
- Diversified management of pension reserves

- Safety – Mutual responsibility
  - In case of insolvency of an individual fund liabilities are transferred to system level (allocated to remaining pension funds)

- Funding
  - Partly funded, partly pay-as-you-go

Size of the pension fund assets

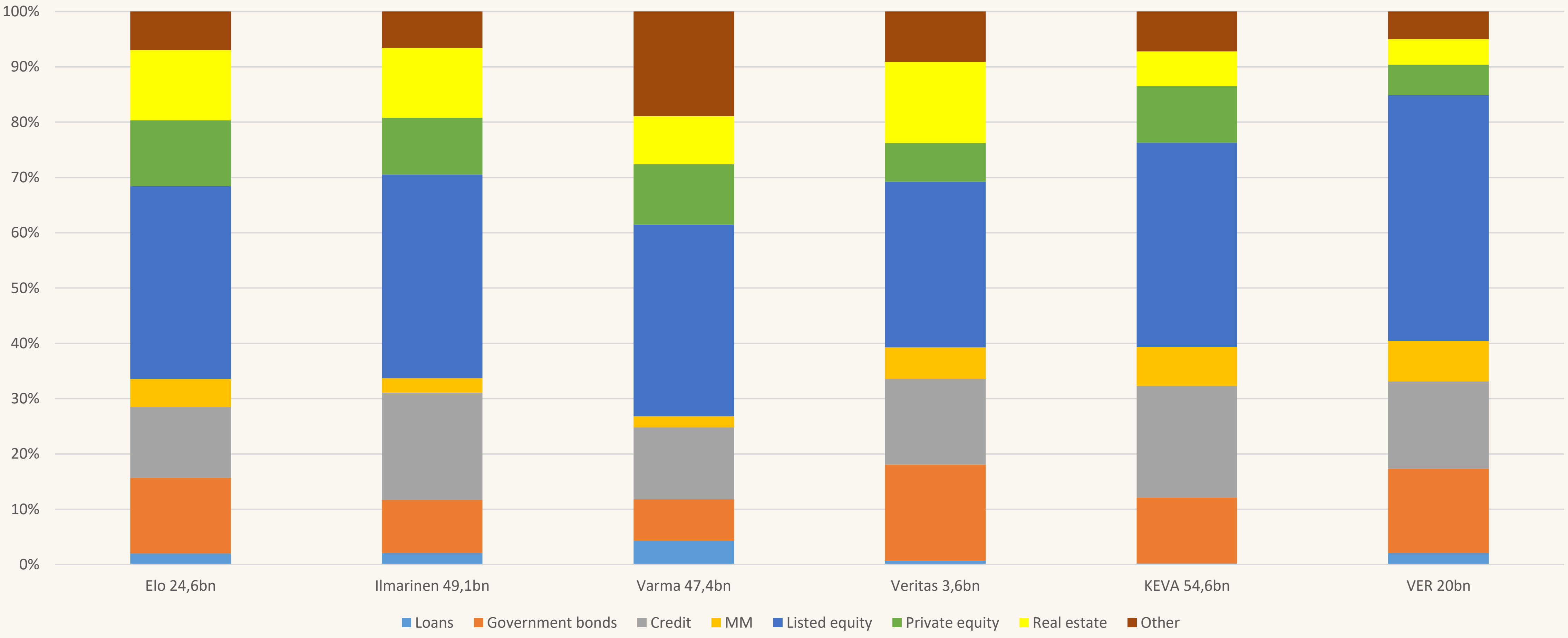
- Finnish GDP approx eur 225 bn
- Assets under management concentrated in few funds
- Regulatory framework allows flexible asset allocation
- Advanced use of derivatives and investment strategies



Data source: Finnish Centre for Pensions

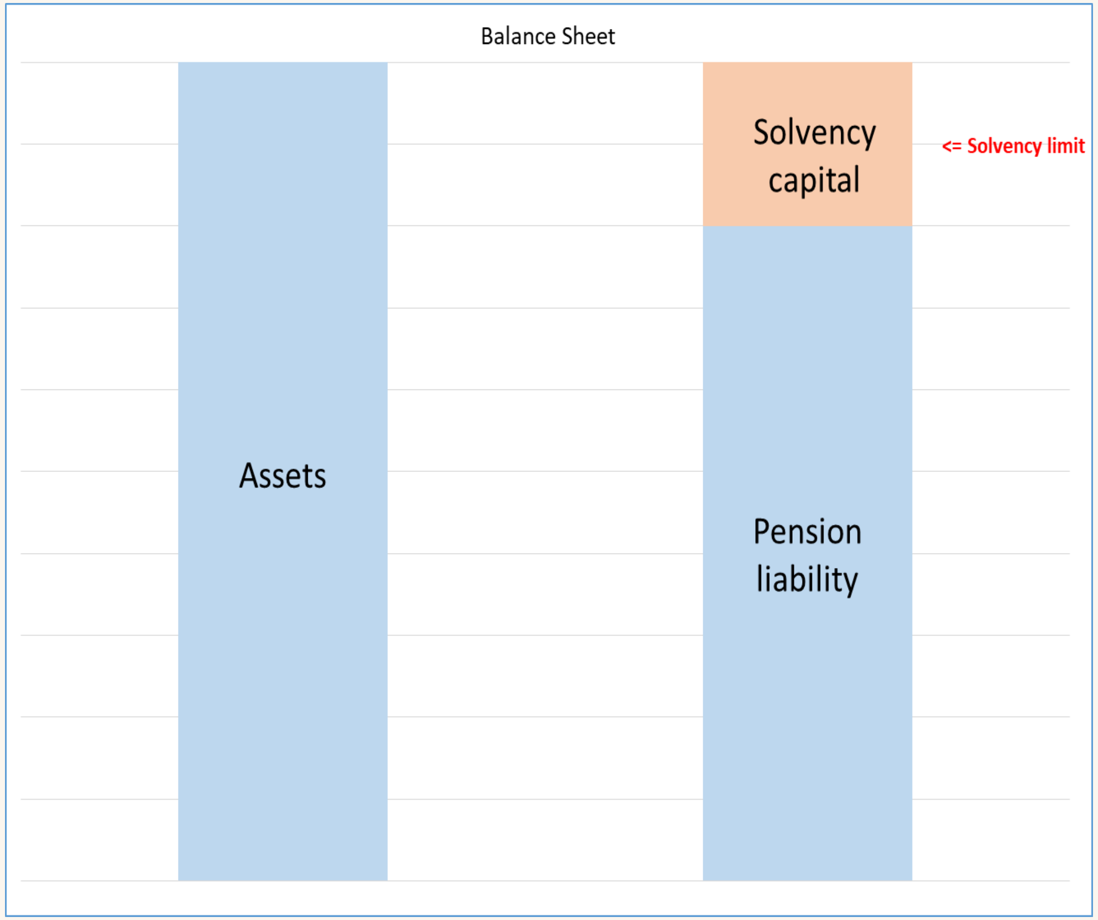
Allocation and liquidity differences

30.9.2019



Data source: The Finnish Pension Alliance TELA. Local Gov PF (KEVA) and Gov PF (VER) operate under different regulatory framework compared to private PF's.

Solvency and the dynamics of assets and liabilities



- Ability to take risk:
  - The level of solvency limit depends on the riskiness of the assets (portfolio)
- Yield requirement for liabilities
  - 3% Fixed
  - Equity return linked factor
  - Supplementary factor which depends on average solvency ratio
- ***Need to take risk due to yield requirement and benchmarking with the competitors***

Low yield environment

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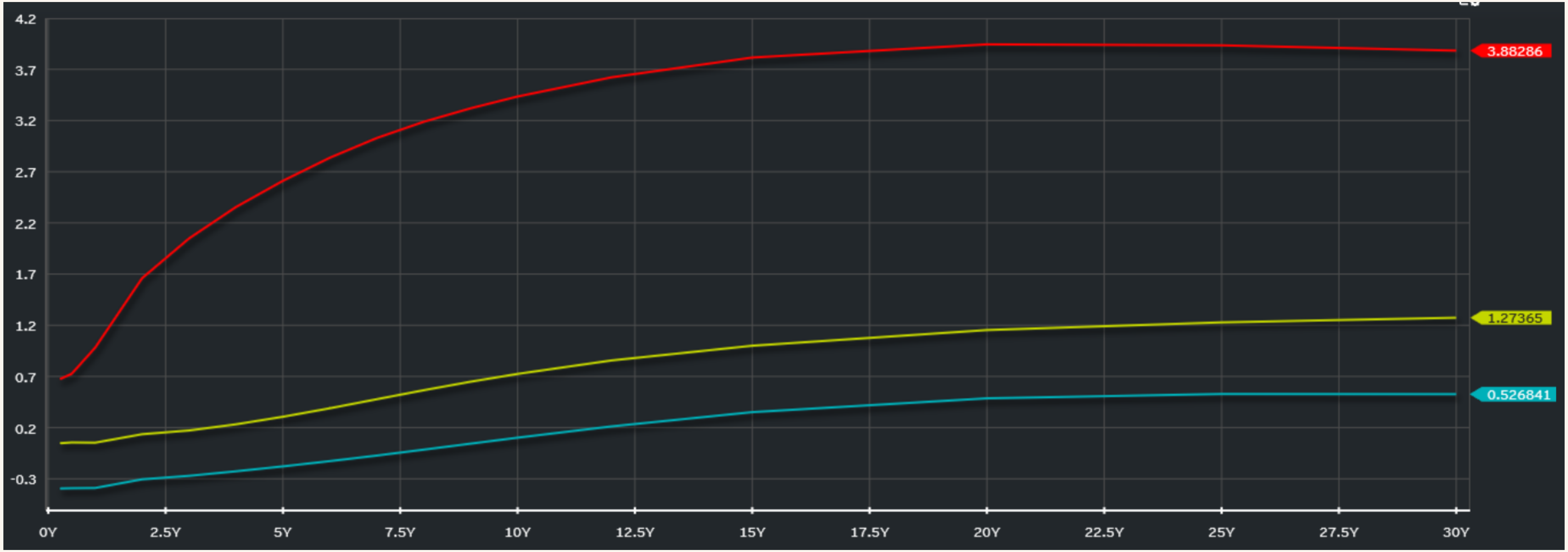
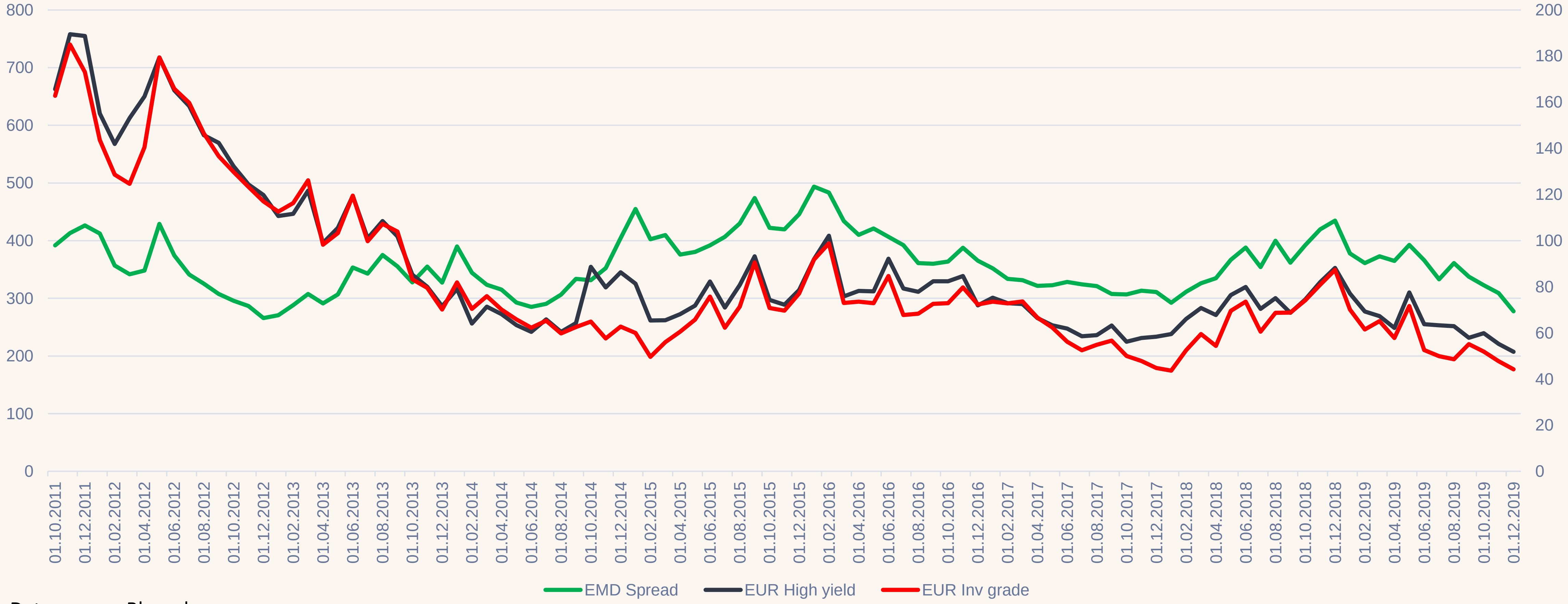
EUR swap yield curve 2010, 2015, 2020



Data source: Bloomberg

Credit spreads

Investment grade, high yield & emerging markets



Data source: Bloomberg

Remarkable returns in all asset classes after GFC

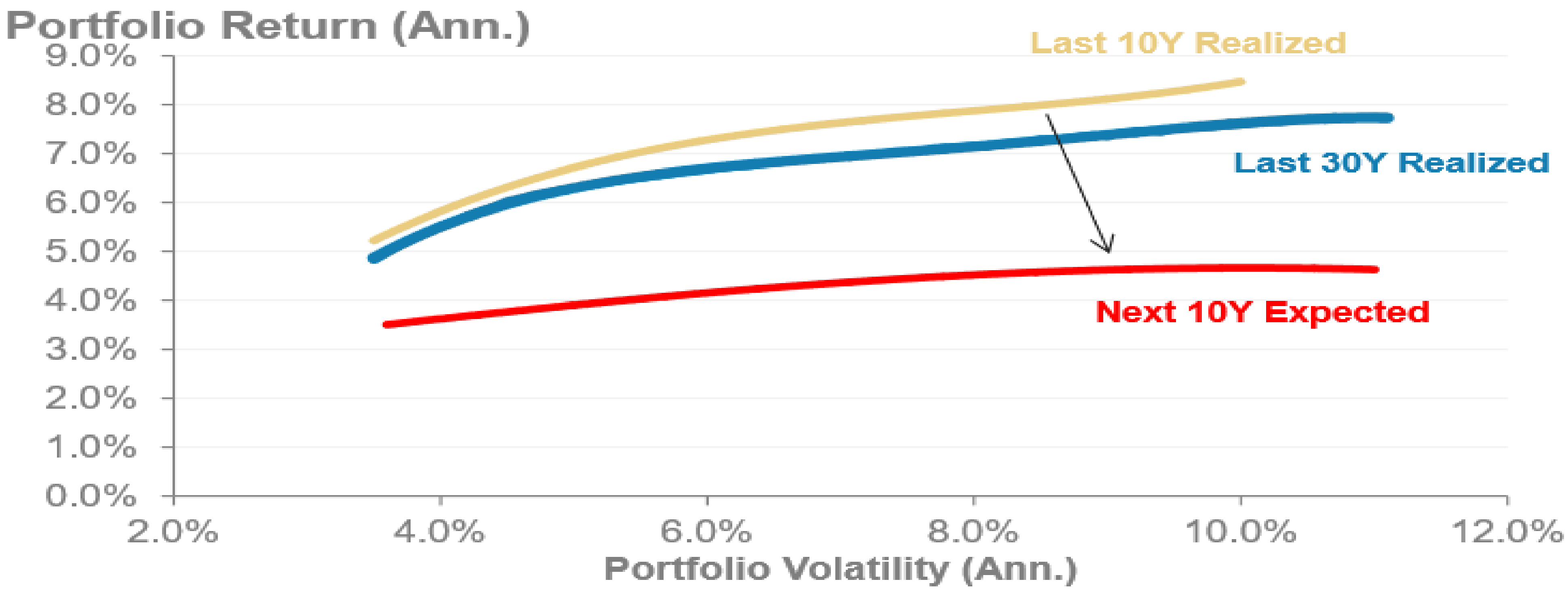
Bloomberg Barclays EuroAgg Government Total Return , Bloomberg Barclays US Govt Total Return, EURO STOXX 50 Gross Return, SP500 Total Return index,

Lähde: Bloomberg.

Looking forward: ex ante low return environment

Efficient frontier for EUR based investor

Exhibit 18: EUR investors face a similar challenge of a lower and flatter efficient frontier



Source: Morgan Stanley Research forecasts; Note: Based on realized and expected nominal returns, realized correlation and vol of MSCI Europe, DBR 10Y, EUR IG, EUR HY and cash, with min 0%, max 60% asset weight constraint for fixed income, min 0% max 80% for equities and min 0% max 10% for cash.

Implied volatility at historic lows

Even though fundamental political risks:

- Globalisation, free trade, supply chains => fragmentation, trade barriers, national interests
- Inequality => political polarisation
- Climate change, immigration

Data source: Bloomberg

SUOMEN PANKKI EUROJÄRJESTELMÄ FINLANDS BANK EUROSYSTEMET

Portfolio rebalancing

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Portfolio rebalancing (search for yield)

- Fixed Income: down the credit curve
  - Government bonds
    - from EU to rest of the world including emerging markets
    - FX risk
  - Corporate bonds
    - from EU IG to rest of the world IG/HY/leveraged loans
- More equity risk
  - Dividends, growth
- Increase illiquidity
  - listed to unlisted investments
  - real estate, infrastructure
  - private equity and credit

Portfolio rebalancing (search for yield)

- Complexity and leverage
  - Structured credit
  - Down in capital structure
    - For example from banks covered bonds to contingent capital
- Less transparency
  - Hedge funds
- Selling volatility (as opposed to buying protection)

Search for alternative sources of risk

- Systematic risk premiums
  - Rule based investment strategies
  - *Historically* consistent strategies plus diversification benefits (correlations)

- Increased demand for passive (alternative) betas
  - Factor investing
  - Thematic investing: ESG
  - Low vol & dispersion (hard environment for alpha)

Universal phenomenon for investors / savers

- Lack of ”risk free” assets

- Generating cash flow
  - Hearding behaviour: into anything which ”carries” or yields

- Search for alternative return sources

- ***=> similar drivers for portfolio construction***
  - ***Concentrated risk positions***

Financial Stability Aspects

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Succesful recovery from GFC, familiar symptoms developing

- The recovery from GFC has been generous for investors portfolios’ in terms of very strong retruns and systemic risks have been avoided

- However, some similarities to period of great moderation are rising
  - Universal hunt for yield
  - Ex ante quality of risk taking
  - Concentrated risk positions
  - Vulnerability
  - Endogenous risks
  - Illiquid underlying assets
  - Extremely low volatility

- In a prolonged “low for very long” scenario investors are encouraged to increase their exposure to riskier and more illiquid asset classes in order to cope with profitability and solvency targets.

Financial stability aspects: vulnerability

- There are only few investors who are able to invest countercyclically
- Who can add risk in a distressed market situation?
- Ability to survive in a drawdown
- Synchronous behaviour, rising correlations?

Financial stability aspects: volatility and illiquidity

- Local, extreme volatility spikes, no significant contagion
  - Spring 2018: VIX unwind, BTP’s, EURTRY
- Volatility paradox (Brunnermeier & Sannikov 2014)
  - Endogenous / exogenous risks
- Illiquidity and transparency of investment portfolios

Thanks!

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